United States Court of Appeals

for the Second Circuit

BRIEF FOR APPELLANT

ORIGINAL

1/31

76-7528

To be argued by
ROBERT A. BICKS

United States Court of Appeals

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FOR THE SECOND CIRCUIT

UNITED STATES STEEL AND CARNEGIE PENSION FUND, INC., CONNECTICUT MUTUAL LIFE INSURANCE COMPANY, and THE NATIONAL BANK OF COMMERCE OF DALLAS (AS TRUSTEE OF THE OMEGA-ALPHA, INC. POOL TRUST),

Plaintiffs-Appellants,

P/S

—against—

HENRY ORENSTEIN, FIRST NATIONAL CITY BANK, HAYDEN STONE INC., BERNSTEIN-MACAULEY, INC., ROGER S. BERLIND, AND SANFORD I. WEILL,

Defendants,

—and—

FIRST NATIONAL CITY BANK,

Defendant-Appellee.

UNITED STATES COURT OF APPEALS
FILED
JAN 31 1977
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SECOND CIRCUIT

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF OF PLAINTIFFS-APPELLANTS

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Every person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under sections 77k or 77l of this title, shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.

Section 17(a)—15 U.S.C. § 77q(a): Fraudulent interstate transactions

(a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

II. Securities Exchange Act of 1934:

Section 10(b)—15 U.S.C. § 78j(b): Manipulative and deceptive devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

* * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b-5 promulgated under Section 10(b)—17 C.F.R. § 240.10b-5: Employment of manipulative and deceptive devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

Section 20(a)—15 U.S.C. § 78t(a): Liabilities of controlling persons

(a) Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

United States Court of Appeals

For the Second Circuit

Docket No. 76-7528

United States Steel and Carnegie Pension Fund, Inc., Connecticut Mutual Life Insurance Company, and the National Bank of Commerce of Dallas (As Trustee of the Omega-Alpha, Inc. Pool Trust),

Plaintiffs-Appellants,

—against—

Henry Orenstein, First National City Bank, Hayden Stone Inc., Bernstein-Macauley, Inc., Roger S. Berlind, and Sanford I. Weill,

Defendants,

—and—

First National City Bank,

Defendant-Appellee.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF OF PLAINTIFFS-APPELLANTS

Preliminary Statement

Plaintiffs United States Steel and Carnegie Pension Fund, Inc. (the "Pension Fund"), Connecticut Mutual Life Insurance Company ("Connecticut Mutual"), and the National Bank of Dallas (the "Dallas Bank") appeal from a judgment entered September 21, 1976 (A20ss)* in the

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* Page references prefixed "A" are to the Joint Appendix on appeal.

United States District Court for the Southern District of New York after a three-week bench trial before the Honorable Whitman Knapp, dismissing their complaint against defendant First National City Bank ("Citibank") under the Securities Act of 1933, the Securities Exchange Act of 1934, and the common law. Judge Knapp's opinion, filed August 4, 1976, as supplemented on September 15, 1976, appears at A21; the unsupplemented opinion appears at [Current] Fed. Sec. L. Rep. (CCH) ¶ 95,680.

Issues Presented for Review

1. Based on facts either found by the District Court or otherwise not in dispute, is Citibank, which had an investment advisory agreement with the Pension Fund and acted as lead commercial banker to Topper Corporation ("Topper"), liable to plaintiffs under the federal securities laws for knowingly misrepresenting the true financial condition of Topper in a report to the Pension Fund made in connection with the private placement of Topper securities on September 28, 1971 (the "Private Placement")?

2. Did Citibank's conduct prior to the Private Placement—including the fact that Citibank required consummation of the Private Placement as a condition to its continued financing of Topper and then, to its own benefit, failed to reveal that and other material facts relating to Topper's financial condition—operate as a fraudulent course of business on plaintiffs or constitute an improper exercise of control over Topper in violation of the federal securities laws?

3. Did Citibank have an affirmative duty of disclosure to plaintiffs because, as an insider, it voluntarily undertook to provide information about Topper to the Pension Fund, with whom it had a special relationship, in connection with a securities transaction which it both required and enabled Topper to consummate and which, when consummated, benefited Citibank?

4. Was the District Court finding that a senior Citibank officer acted in "good faith" when he misstated and concealed material facts from the Pension Fund induced by an erroneous view of the law or, alternatively, was it a clearly erroneous inference in light of the great weight of more probative evidence?

5. Is Citibank liable to the Pension Fund for breach of common law duties arising out of a 1950 agreement between the parties, obliging Citibank to provide "investment advice," when Citibank failed to disclose, upon request by the Pension Fund, material information within its possession concerning Topper's financial condition?

Statement of the Case

A. Nature of the Case

This action arose out of the private placement of $5,250,000 of Topper convertible subordinated notes on September 28, 1971. At the time of the Private Placement, Topper was engaged in the business of manufacturing and marketing toys for boys and girls (Fdg P1).[1] The Pension Fund purchased $3 million of the Topper notes, Connecticut Mutual purchased $1 million and the Dallas Bank bought $250,000 (Fdg P2). Since 1966 Citibank and Topper were parties to a Finance Agreement pursuant to which Citibank advanced moneys to Topper on a secured basis and acted as agent for other lenders that at various times also advanced moneys to Topper (Fdg P48). In addition, since 1950 both the Pension Fund and Citibank were parties to an agreement under which Citibank agreed, for an annual fee, to provide investment advisory and other services to the Pension Fund (Fdg D272).

The day following the Private Placement, Topper remitted the entire proceeds of the offering to Citibank in repayment of a "bridge" loan recently extended by Citibank. The District Court found "that Topper was only

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[1] The designations "Fdg P" and "Fdg D" refer to those Findings of Fact proposed by plaintiffs and defendant, respectively, which were subsequently adopted by the District Court; they appear at pages A41-A348 of the Joint Appendix.

able to continue operations during the summer of 1971 as a result of [this] bridge loan" and that Citibank agreed to extend the loan only "on the condition that Topper consummate the Private Placement and remit its proceeds to the bank" (Fdg P193). Neither the existence nor the conditions of the bridge loan were revealed to plaintiffs (Fdgs P193, P315).

Plaintiffs' claims against Citibank are based on the fact, also found by the District Court, that a month prior to the Private Placement a senior Citibank officer "gave a favorable report on Topper's current financial condition" to the Pension Fund as lead investor in the Private Placement (Fdg P20). The fact of Citibank's favorable report on Topper's financial condition was conveyed to Connecticut Mutual prior to its decision to purchase the Topper securities (Fdg P21), and the District Court found that "[b]oth the Pension Fund and Connecticut Mutual in fact relied on Citibank's favorable report on Topper's current financial condition in connection with their decision to participate in the Private Placement" (Fdg P22).

Within two months of the Private Placement, Topper announced that it would suffer a significant loss for 1971, a loss which ultimately amounted to more than $37 million (Fdgs P196-P200). Topper was declared bankrupt on May 7, 1973 and plaintiffs' investment has long since been worthless.

B. The Proceedings Below

On January 23, 1974 plaintiffs commenced this action against Citibank, Hayden Stone Inc. ("Hayden Stone") which served as Topper's investment banker, and certain individual officers and directors of Topper, including its president, Mr. Henry Orenstein. Plaintiffs' claims against all defendants except Citibank were settled prior to trial.

Following trial, the District Court found that in the months prior to the Private Placement Topper was in the midst of a severe financial crisis,[2] that each significant fact

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[2] *See infra* at 8-10.

relating to that financial crisis was known to Citibank,[3] and that in connection with the Private Placement Citibank gave a favorable report on Topper's current financial condition to the Pension Fund without revealing any of the adverse information that Citibank knew concerning Topper's financial difficulties (Fdg P20). The District Court held these facts to be insufficient to sustain any cause of action against Citibank because the particular Citibank officer who reported to the Pension Fund "acted in good faith" and had no "conceivable motive to mislead" the Pension Fund (A27-A28). The District Court also found that had another Citibank officer talked to the Pension Fund, "an entirely different result might have followed" (A1526). Based on its view of the facts, the District Court concluded "there really is no law to discuss" (A28) and dismissed plaintiffs' complaint.

C. Statement of Facts

In an appendix to its opinion (A32-A39), the District Court adopted certain findings of fact proposed by the parties (A41-A348). The following statement of facts is, with the exception of facts agreed to by the parties, drawn exclusively from those findings.

(i) *Plaintiffs' View of Topper Prior to the Private Placement*

Topper was portrayed to plaintiffs as a company which, save for one period in the mid-1960's, had experienced phenomenal growth from a two-man toy distributor in 1953 to the fifth largest domestic toy company by 1971 (Fdgs P42-P46). Financial statements for the year ended December 31, 1970, certified by Topper's independent auditors, Arthur Young & Company ("Arthur Young"), indicated that Topper was a financially stable company which had experienced steadily increasing profits in the years preceding the Private Placement (Fdg P8). Interim financial statements provided by Topper management reflected record sales and earnings for the first six

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[3] *See infra* at 11-13.

months of 1971 (Fdg P10), and projections for the remainder of the year indicated these favorable financial trends would continue (Fdg P11). The Private Placement, plaintiffs were told, would provide further financial stability by lessening dependence on a secured bank loan and reducing the effective cost of interest to Topper (Fdgs P15-P16).

As far as Topper's business was concerned, the company manufactured a wide range of toy products and had recently acquired the right to make and distribute a line of educational playthings under the Sesame Street name (Fdg P23). It was further represented that Topper's product line had received an excellent reception in the first part of 1971 and was selling on a year-round basis (Fdg P17), thus lessening Topper's dependence on sales during the Christmas season. This year-round sales pattern was achieved, plaintiffs were informed, principally as a result of the success of a small, low-priced fashion doll sold under the Dawn name (Fdgs P24-P26). Plaintiffs were told that Topper sold approximately $14 million of Dawn dolls in December 1970, that this merchandise had been sold at retail in 1971, and that customers had reordered additional quantities for the coming Christmas season (Fdgs P25-P27).

(ii) *The False and Misleading Nature of the Financial Information Provided to Plaintiffs*

Contrary to this image of financial stability, the District Court found that at the time of the Private Placement Topper was in fact laboring under "several and severe financial problems" (Fdg P193). Rather than being one of the most successful toy lines in the country, Topper's Dawn line had failed to sell at retail in 1971 and was being returned to Topper in substantial quantities (*id.*). As a result, since May 1971 Topper had been "in the midst of a serious cash flow problem" with customer collections falling short of projections by $10.5 million (*id.*). Topper's principal asset, its accounts receivable, had deteriorated to the point where, by the time of the Private Placement, approximately 50% were deemed unworthy as collateral by Citibank (*id.*), and the company's net worth was in

jeopardy (Fdg P184). The District Court found that in the months preceding the Private Placement Topper was "unable to generate sufficient cash to pay for operations and was presently experiencing a negative cash flow of more than $8 million" (Fdg P193). Topper's condition was such that it "was only able to continue operations during the summer of 1971 as a result of a bridge loan which Citibank agreed to extend only on the condition that Topper consummate the Private Placement and remit its proceeds to the bank" (*id.*). The Private Placement was effected, the Court concluded, "without the slightest disclosure" of any of these financial problems to the plaintiffs (*id.*).

(iii) *Topper's Operations First Faltered in 1970*

The financial crisis at Topper in 1971, which was first publicly revealed two months after the Private Placement (Fdgs P196-P197), had its origins in 1970. Following losses in 1965 and 1966, Topper showed marked financial improvement during the three-year period ending December 31, 1969 (Fdgs P8-P9) principally because of its ability to design a product line which fared well at retail. Although Topper had formally discontinued certain return practices which gave rise to its difficulties in the mid-1960's, it maintained an informal practice, known to insiders but not to the public or to plaintiffs (Fdgs P83-P88), of granting concessions to customers who were unable to sell Topper toys at retail (Fdgs P57-P76). Concessions granted customers were generally effected by issuing credits against outstanding accounts receivable (Fdgs P78-P80), which had the effect of reducing both sales and receivables (Fdg P80) and thus was a crucial parameter in determining profitability (Fdgs P82, P122, P154).

As 1970 began, Topper expected that its success in the prior three years would continue, and accordingly prepared a conservative set of projections for Citibank which showed that sales and profits would advance significantly beyond the record earnings of 1969 (Fdgs P109-P111). This anticipation proved unwarranted, as sales of two of Topper's principal toy products fell off sharply in 1970 (Fdg

P117). By November 30, 1970, at the close of the period which for Topper was considered the year-end (Fdg P121), net sales were $16.3 million below the conservative projections submitted to Citibank in January 1970 and net profit was off by more than $3.6 million (Fdgs P115-P121). Reflecting the failure of Topper's product line, the amount of credits issued for customer concessions doubled from $9 million in 1969 to more than $19 million in 1970 (Fdgs P81-P82, P122).

To shore up its faltering toy operations, on paper at least, in December 1970 Topper embarked on what an Arthur Young partner later described as "an unusual program" never tried on a material scale before (Fdg P137). Under this program, known as the Spring 1971 Program, customers were invoiced approximately $16 million of toys, principally Dawn, in late December 1970 on extended credit terms of five to eight months (*id.*). The heavy Dawn shipments in December were made despite warnings from principal distributors that the product was already overstocked on retail shelves (Fdg P143).

As a result of treating the Spring 1971 Program as a 1970 event, Topper was able to report a net profit for 1970 of $353,000. Without the Spring 1971 Program, Topper would have suffered a loss exceeding $6 million for 1970 (Fdgs P151-P152). Only the barest outline of the Spring 1971 Program was disclosed to plaintiffs prior to the Private Placement (Fdgs P155-P157).

(iv) *The Financial Crisis at Topper During 1971*

Topper's financial fortunes for 1971 were, in significant measure, tied to its ability to collect the $16 million in Spring 1971 Program receivables due between May and August 1971 (Fdgs P158-P159, P175). This in turn required, because of Topper's concession policy, that its expressed goal of selling the low-priced Dawn merchandise during the first half of the year in fact be met (Fdg P160). Anticipating such a market success, in January 1971 Topper prepared and submitted to Citibank a financial plan for 1971 which projected collection of the Spring Program

receivables during the May through September period (Fdg P160). Topper's projections envisioned only one outside financing of $3 million in 1971 (Fdg P161).

Within a month of these projections, however, serious questions arose relating to Topper's financial assumptions for 1971. In early February 1971, Topper customers started reporting a heavy build-up in Dawn inventories (Fdgs P162-P163), a development which first appeared two months earlier in December 1970 (Fdg P143). With Dawn accounting for roughly 80% of Topper's receivables in 1971 (Fdg P160), the impact of this growing backlog was immediate: Within a month of its original projections, Topper increased its planned outside financings from one to two, and now recognized that it would need $10 million, rather than $3 million, in outside funds to support its 1971 operations (Fdg P164).

By April 1971 it was evident that the avowed purpose of the Spring 1971 Program, namely to enable sale of the low-priced and non-seasonal Dawn merchandise during the first months of the year, would not be achieved (Fdgs P168-P170). The failure of Dawn to retail as originally anticipated, together with the recognition that Citibank had or was about to deem a substantial amount of receivables ineligible as collateral (Fdgs P101, P105, P216, P284), intensified Topper's impending cash needs (Fdg P171). To meet such needs, Topper again increased, from two to three, the number of proposed financings from outside investors, and now realized that without a substantial reversal in Dawn's fortunes at retail, it would need approximately $18 million in outside financings to support its 1971 operations (Fdg P172).

As spring turned to summer in 1971, Topper's worst fears became the fact: Customers simply failed to pay their receivables on the growing volume of unsold Dawn merchandise (Fdg P176). During the months of May through September 1971, actual cash collections fell short of projected collections by $10.5 million, or 41% of the revenues Topper required to run its business during this period (Fdgs P176, P188). Directly related to this shortfall in collections was the sharp jump in the amount of past

due receivables which increased nearly 600% from the end of June to the end of July 1971, from $1.3 million to $7.2 million (Fdg P178). By the time of the Private Placement the total amount of receivables ineligible as collateral for advances under the Finance Agreement with Citibank stood at $17.1 million, compared to $5 million at the end of January (*id.*). Equally serious questions were raised concerning the value of Topper's current receivables because the underlying product had failed to sell (Fdg P183).

The deterioration in Topper's receivables was such that by the end of August 1971 the company's net worth was in jeopardy (Fdg P184). Operations were equally affected because the failure of Topper customers to sell their previously purchased Dawn inventory substantially limited Topper's ability to sell these customers merchandise in 1971 (Fdg P186)—in effect, Topper's unsold and unpaid for merchandise was in competition with its new fall and Christmas merchandise (Fdgs P186-P187).

As a result of these difficulties, Topper was unable to generate sufficient cash receipts to pay for its operations during the late spring and summer of 1971 (Fdg P188). By the end of August 1971 Topper was suffering a negative cash flow of nearly $8 million (*id.*) and its prospects, according to a Price Waterhouse accountant who testified at trial, "were pretty bleak" (Fdg P189). The problem of receivables was "having a ripple effect with the entire operation," and without some outside financing Topper would not "have been able to continue as a going concern" (*id.*).

Topper was able to continue operations through the summer of 1971, not by selling more toys or collecting more receivables, but instead by raising more funds from outside investors (Fdg P191). During the months of May through September 1971, Topper received $15.7 million from toy operations and $18.5 million from outside financings (Fdg P192). The $18.5 million in outside financings raised by Topper during this period was remitted to Citibank in its entirety (*id.*).

(v) *Citibank's Actual Knowledge of Topper's Financial Difficulties*

As Topper's commercial banker, Citibank possessed a wide range of financial data not known by any plaintiff. Each business day Citibank, in addition to consulting with Topper officers, received voluminous schedules and reports from the Topper finance department (Fdgs P210-P211). These materials were then fed to a Citibank computer that was programmed to prepare a daily report called an "advance sheet" which reflected the essential results of all daily records prepared by Topper (Fdgs P212-P213). With this information at hand, Citibank was able to keep abreast of each adverse financial development which occurred at Topper in 1970 and 1971.

Initially, Citibank was aware of Topper's disappointing performance in 1970 (Fdgs P126-P133), including the $16.3 million shortfall in projected sales (Fdgs P131, P115) and the sharp increase in customer credits (Fdgs P129-P130).[4] Citibank was first aware of Topper's problem with its Dawn line at the end of October 1970, a month or so before Topper customers themselves warned of overshipments (Fdgs P129, P143). Although Citibank believed its loan was reasonably secured at the end of 1970, Citibank thought Topper should be "watched very closely due to the uncertainty of the economic climate and the inherent problems in the Toy Industry" (Fdg P132).

As 1971 began, Citibank was advised that Topper planned only one outside financing to support toy operations in the coming year (Fdg P239). A month later, on February 23, 1971, Citibank was informed by Topper that in addition to a public offering set for May, which had been expanded from $3 to $5 million, Topper was planning a second financing of $5 million from an institutional investor (Fdg P240). On this same day Citibank agreed to continue financing Topper through the end of 1971 (Fdg P241). Soon thereafter, Citibank learned that even two outside financings would be insufficient to overcome Topper's financial prob-

[4] Citibank was aware of the significance of these credits, both to Topper's operation and its own collateral (Fdgs P93, P95-P99).

lems and that Topper now planned to go forward with three financings which, taken together, would bring in more than $18 million in outside capital to support 1971 operations (Fdg P272).

Citibank was also aware of the significance of the $16 million of Spring Program receivables, due between May and August, to Topper's 1971 operations (Fdgs P253-P254). Within nine days after the $9.5 million in May 10 receivables fell due, Citibank compared actual collections against projections and found that collections in May were approximately $1.4 million versus the $5.5 million projected for the month (Fdg P253). Citibank continued to follow Topper's cash collections as the summer of 1971 progressed, and was consequently aware of the unprecedented cash shortfall of more than $10 million which occurred during the critical months of May through September 1971 (Fdgs P254-P255).

Finally, Citibank closely monitored the substantial deterioration in Topper receivables, including the surge in past due and ineligible receivables which occurred between the end of June and the end of July 1971 (Fdgs P257-P258). Significantly, Citibank knew that the reason for the increase in past due receivables was the failure of Dawn merchandise to sell at retail and not the inability of customers to pay (Fdg P259). Confirming this, Citibank learned in the spring and early summer of 1971 that the amount of credits issued for returns and like concessions covering unsold merchandise was running at twice the rate Topper experienced in 1970 (Fdg P263) and four times the rate in 1969 (*cf.* Fdg P82).

The complete deterioration in Topper's business was shown most dramatically by the fact that by August 27, 1971, the day of the Citibank report to the Pension Fund, nearly 50% of Topper's principal asset, its accounts receivable, was deemed unworthy as collateral by Citibank (Fdg P264). The impact of these adverse collection and receivable problems on Citibank's lending plans for 1971 was unmistakable. Thus in late February senior Citibank officials had instructed their staff that after May advances

to Topper over the collateral limits of the Finance Agreement ("over-advances") were not to exceed $500,000. From early May through the end of August 1971, however, there was a negative swing of $6.5 million in Topper's advance position (Fdg P268), and over-advances climbed to $5 million, ten times the limit on permissible over-advances which Citibank had established in February (Fdg P269).

(vi) *Citibank Agreed to Continue Financing Topper Only on the Condition That Topper Effect the Private Placement and Remit Its Proceeds to Citibank*

Within a month of learning that collections under the Spring 1971 Program were falling substantially short of projections, Citibank met with Topper officials on two occasions to discuss its financial plans for the remainder of the year (Fdgs P271-P272, P274). At a meeting with Citibank officials on June 21, 1971, Topper, in light of the growing shortfall in collections, sought Citibank's approval to go beyond the Advance Instructions set earlier in the year (Fdgs P241-P242, P274). Citibank agreed to permit an over-advance of $2 million at that meeting, but only on the condition that Topper successfully complete its outside financings and remit the proceeds to Citibank by early August 1971 (Fdgs P274-P275).

When Topper's finances failed to improve in the two or three week period following the June 21 meeting, another session, this one lasting two days, was held between Topper management and Citibank officials on July 13 and 14, 1971 (Fdgs P276-P277). At this meeting Topper management informed Citibank officials that current collection and receivable problems stemmed from the inability of distributors to sell the Dawn merchandise shipped in December 1970 (Fdg P278). Because of these difficulties, Topper management requested that Citibank grant additional over-advances, this time in the amount of $3 million, to support Topper's operations "as a bridge until the debenture funds" were received (Fdg P279). Citibank, which at this point "welcomed" the Private Placement, once more agreed, *but again only on the condition that the Private Placement be consummated* (Fdgs P280-P281).

Contrary to the plans contrived by Citibank and Topper at their mid-July meetings, however, the next six weeks or so failed to show the hoped for financial improvement (Fdgs P282-P284). As a result, Citibank began pressuring Topper to collect past due receivables from customers (Fdg P285). When collections still continued to falter, another meeting was held on or shortly before August 25, 1971, just two days prior to Citibank's report to the Pension Fund, at which time Citibank agreed to a third and final over-advance, nearly twice as great as the maximum which Citibank had previously expected in late June (Fdgs P287-P288), to enable Topper to continue operations until the Private Placement. According to one Citibank officer, Citibank went along at this time only because it knew the "debenture money" was coming in (Fdg P288).

Topper's business continued to deteriorate in September 1971 (Fdg P290) and the Finance Agreement was amended once more, on September 17, 1971, in order to induce the Ford Motor Credit Company to make a $7 million loan to Topper (Fdg P292). On September 28, 1971 the Private Placement was consummated, as anticipated by Citibank on August 25, 1971 (Fdg P293). The following day the $5,250,000 in proceeds was remitted to Citibank (*id.*). In the twelve-day period from September 17 to September 29, 1971, Citibank's *own* share of the outstanding Topper loan was reduced by $5.3 million, from $8.5 million to $3.2 million (Fdg P295).

(vii) *Citibank's Favorable Report to the Pension Fund*

During the course of their investigation which preceded the Private Placement, both the Pension Fund and Connecticut Mutual were told by Topper management that Topper had a close working arrangement with Citibank and that Citibank received voluminous financial reports prepared by Topper on a daily and monthly basis relating to cash collections and receivables (Fdg P18). Both plaintiffs were told by Topper management that they were free to speak to Citibank "to get information about Topper's financial condition" (*id.*).

Moreover, since 1950 Citibank had provided the Pension Fund with various investment services pursuant to a written agreement between the parties (Fdg D267). Among other things, the 1950 agreement obliged Citibank to provide the Pension Fund with investment advice (Fdg D272) for an annual fee which ranged between $20,000 and $25,000 a year (A1672). Among the investment advisory services rendered by Citibank over the years was providing the Pension Fund with information from its own files in connection with proposed private placements being considered by the Pension Fund (Fdgs D276-D279).

Because it had not independently verified Topper's current financial state, the Pension Fund decided that an inquiry to Citibank was appropriate in connection with the Private Placement (Fdgs P19, P297). Accordingly, on August 25, 1971 a representative of the Pension Fund, Mr. Henry Thompson, telephoned the liaison officer at Citibank responsible for the Pension Fund account, Mr. Walter Jeffers. According to Citibank:[5]

> "Thompson told Jeffers that Thompson had been told that he was free to check with Citibank and to obtain any information that he was interested in about Topper. He then asked Jeffers for whatever information Citibank had. Jeffers, who had never heard of Topper, asked Thompson for his phone number and said that someone would get back to him."

Shortly after this conversation, Jeffers contacted the senior Citibank officer responsible for the Topper account, Mr. Edward Waldman, and asked him to call Thompson at the Pension Fund (Fdg P305). In response to Jeffers' request, Waldman telephoned Thompson on the afternoon of August 27, 1971 (Fdg P306). Prior to doing so, Waldman reviewed and initialed the August 26, 1971 Citibank advance sheet which summarized the current state of

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[5] Proposed Findings of Fact and Conclusions of Law of Defendant First National City Bank, Record # 151, ¶ 230. *See infra* at 41 n.38.

Topper's finances (A1747; *see* PX 1442 at Addendum to this brief). According to the District Court, at the time he telephoned Thompson, Waldman knew that Thompson represented the Pension Fund (Fdg P307); that the Pension Fund was considering the purchase of unsecured Topper notes (*id.*); that Citibank would receive the proceeds of any investment the Pension Fund would make (A1535); that United States Steel had a relationship with Citibank (Fdg P307); and that Thompson "wanted all the information necessary" to evaluate the Private Placement (*id.*).

The District Court adopted the following account of the Waldman-Thompson conversation:

> "In response, the senior Citibank officer responsible for the Topper account called the Pension Fund on August 27, 1971 and gave a favorable report on Topper's current financial condition. Among other things, Citibank represented to the Pension Fund that Topper had performed well in a Citibank audit of its receivables, that Topper's principal product line was faring well at retail, that there were no current problems with the Topper account and that Citibank anticipated none" (Fdg P20).

Waldman himself subsequently acknowledged to other Citibank officers, as well as to representatives of the Pension Fund, that he had given Thompson a favorable report during the course of their August 27, 1971 conversation (Fdgs P320-P321). The fact of Citibank's favorable report on Topper's financial condition was conveyed shortly thereafter to Connecticut Mutual (Fdg P21). Both the Pension Fund and Connecticut Mutual relied on Citibank's favorable report about Topper's financial condition in connection with their decisions to participate in the Private Placement (Fdg P22).

ARGUMENT

I.

Citibank's Knowing Misrepresentations of Material Facts Give Rise to Liability Under the Federal Securities Laws.

Plaintiffs' claim of liability here rests neither on a theory of negligent nonfeasance as in *Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185, 190 (1976), nor on a theory of reckless disregard as in *Lanza* v. *Drexel & Co.,* 479 F.2d 1277, 1306 (2d Cir. 1973). Instead plaintiffs' claims under Rule 10b-5, 17 C.F.R. § 240.10b-5, and Section 17(a), 15 U.S.C. § 77q(a), are based on the fact, found by the District Court, that Citibank had actual knowledge of the several and severe financial problems at Topper and, when asked for whatever information it had, misstated and concealed the facts it knew relating to the financial crisis at Topper.

A. Facts Known to Citibank Were Material Under the Federal Securities Laws

Initially at issue is whether the financial information known to Citibank was material within the meaning of the federal securities laws, a question not expressly addressed by the District Court. In deciding materiality,

> "The proper test is whether the plaintiff would have been influenced to act differently than he did act if the defendant had disclosed to him the undisclosed fact." *List* v. *Fashion Park, Inc.,* 340 F.2d 457, 463 (2d Cir.), *cert. denied,* 382 U.S. 811 (1965).

Here financial information known to Citibank concerning Topper's cash flow, receivables, sales and loan status—which the District Court found comprised the "several and severe financial problems" at Topper (Fdg P193)—was plainly material. The SEC has long made clear that "liquidity problems such as a decreased inflow of collections from sales to customers" are material facts which must be disclosed to the investing public. Exchange Act Release No.

34-8995, 17 C.F.R. § 241.8995, Fed. Sec. L. Rep. (CCH) ¶ 23,120A (1970); *see SEC* v. *American Associated Systems, Inc.*, 482 F.2d 1040 (6th Cir. 1973), *cert. denied*, 414 U.S. 1130 (1974). At Topper the significance of the cash flow problem is illustrated by the fact that the $10.5 million collection shortfall during the period May through September 1971 constituted 41% of the revenues required by Topper to run its business during this period (Fdgs P176, P188). According to Price Waterhouse, the negative cash flow occasioned by this shortfall raised serious questions concerning Topper's ability "to continue as a going concern" (Fdg P189).

It is likewise recognized that adverse developments bearing on the worth of a company's receivables are material to investors. *See United States* v. *Eskow*, 422 F.2d 1060, 1063 (2d Cir.), *cert. denied*, 398 U.S. 959 (1970); *Jordan Building Co.* v. *Doyle, O'Connor & Co.*, 401 F.2d 47, 48-49 n.2 (7th Cir. 1968). Here the material nature of the deterioration in Topper's receivables is apparent from the fact that receivables accounted for two-thirds of Topper's current assets on August 31, 1971 (A2672) and 50% were deemed unworthy as collateral by Citibank (Fdg P264). Equally significant is the fact that the deterioration was caused, as Citibank knew, by the failure of Topper's principal product line to sell at retail, a product line which comprised two-thirds of Topper's net sales in 1970 (Fdg P141) and 60% of its sales for the first half of 1971 (Fdg P173).

Finally, the conditions of and the circumstances surrounding an issuer's financial arrangements with its lenders are plainly material under the securities laws. *See SEC* v. *Koenig*, 469 F.2d 198, 201 (2d Cir. 1972); *Lehigh Valley Trust Co.* v. *Central National Bank*, 409 F.2d 989, 993 (5th Cir. 1969). The materiality of the $5 million bridge loan is evident, most basically, from the fact that it was necessary to keep Topper in business as a going concern (Fdgs P188-P190, P193) and was only granted by Citibank upon receiving assurances that Topper would replace the funds with outside financings (Fdgs P275, P281, P288).

B. The District Court's Findings Compel the Conclusion That Citibank Misstated and Concealed Material Facts From Plaintiffs

What Citibank said to the Pension Fund on August 27, 1971, like the facts it actually knew, is not now in dispute. The District Court found that "the senior Citibank officer responsible for the Topper account called the Pension Fund on August 27, 1971 and gave a favorable report on Topper's current financial condition" (Fdg P20). As far as Waldman's specific remarks on receivables and the success of the Dawn line are concerned, each constitutes a knowing misrepresentation of a material fact under the Court's findings. Thus the Court found:

> *First,* that Waldman told Thompson "that Topper's principal product line was faring well at retail" (Fdg P20); but also found that Waldman and Citibank knew the Dawn line had in fact failed to sell at retail (Fdg P259) and was being returned in substantial quantities by Topper customers (Fdg P263); and
>
> *Second,* that Waldman told Thompson "that Topper had performed well in a Citibank audit of its receivables" (Fdg P20); but also found that Waldman and Citibank in fact knew that the amount of Topper's past due receivables had increased 300% from the end of June to the end of July (Fdg P257), that by the end of August 1971 the amount of past due receivables was five times the amount outstanding for the comparable period in 1970 and nearly fourteen times as great as in 1969 (Fdg P258), and, most significantly, that nearly 50% of Topper receivables were deemed unworthy as collateral for advances by Citibank (Fdg P264).

Apart from these misstatements, Waldman's favorable report on the financial condition of Topper and his statement that there were "no problems" with the Topper account constitute either another misrepresentation of mate-

rial fact,[6] or the type of "half-truth" long considered the equivalent of a fraudulent misrepresentation. Thus even assuming that Waldman believed there were "no problems" with the Topper account at the time he talked to the Pension Fund, which is itself incredible,[7] he still acknowledges failing to disclose the basic difficulties which prompted four meetings with Topper management and two amendments to the Finance Agreement in the prior two-month period:

> "Q. This is August 27th. Knowing Thompson's purpose and understanding what he wanted from you, did you tell him that Dawn, which was one of Topper's principal product lines, wasn't selling as anticipated? Did you tell Thompson that?
>
> "A. No, I didn't.
>
> "Q. Did you tell him that Topper's collections were lagging significantly below their projections?
>
> "A. No, I didn't.
>
> "Q. Did you tell him that Topper's receivables more than 60 days past due that day totalled $9 million?
>
> "A. No, I didn't.
>
> "Q. Did you tell him that Topper's receivables more than 60 days past due had tripled?
>
> "A. No, I didn't.
>
> "Q. Between August and June.
>
> Did you tell him that the bank had agreed twice in the last two weeks prior to your conversation with Thompson to amend its financial agreement to permit over-advances?
>
> "A. Yes, I knew.
>
> "Q. Did you tell him that?

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[6] Construed as a statement of fact, Waldman's statement that "there were no current problems with the Topper account and that Citibank anticipated none" (Fdg P20) constitutes a knowing misstatement when matched against other findings of the District Court. Thus the Court found that there were "several and severe financial problems" at Topper and went on to find that Waldman and Citibank knew of each of these principal problems (*see, e.g.*, Fdgs P254, P259, P264, P267, P275, P288).

The same conclusion applies if the Citibank report is viewed as a statement of opinion. *See Restatement of Torts* § 539 (1938).

[7] *See infra* at 43-52.

"A. I didn't.

"Q. Did you indicate to him that on the day of your conversation there was an over-advance by the bank almost amounting to $5 million?

"A. No, I didn't" (Fdg P315).

Such testimony alone is sufficient to establish fraud in connection with a securities transaction. Disregarding the material misstatements and omissions, the District Court adopted a scenario which in effect found that Waldman learned of the adverse developments with the Topper account in the early summer; met on several occasions with Topper management to discuss these problems, including a two-day conference on July 13 and 14; and was ultimately persuaded by Topper's President, Mr. Orenstein, that if given more time and money these difficulties could be overcome (*see* A24). Based on this analysis, the District Court concluded that the favorable report to the Pension Fund was justified.

This is error because even if Waldman was personally persuaded on August 27, 1971 that the financial problems discussed with Topper management would be ironed out and that Topper would somehow pull through, he was still obliged to disclose the material facts which prompted the series of meetings with his client in the first instance or, at a minimum, to indicate that such adverse facts existed. This is particularly true because any hope that Citibank may have harbored was contingent on the successful completion of the same Private Placement about which the Pension Fund was inquiring. For this reason, the Court's comment with respect to Orenstein—namely that although he "was quite convinced that he was going to pull this off . . . that doesn't mean that Orenstein [was] entitled to keep the relevant facts from everybody else" (A1613)—applies equally well to Citibank.

Accordingly, Waldman's general remarks that there were no problems at Topper were, at the very least, classic "half-truths—statements which are true as far as they go but are misleading because of the absence of pertinent qualifications." III L. Loss, *Securities Regulation* 1431 (2d ed.

1961). "Such a statement of a half truth is as much a misrepresentation as if the facts stated were untrue." *Equitable Life Insurance Co.* v. *Halsey, Stuart & Co.*, 312 U.S. 410, 426 (1941); *see Restatement of Torts* § 529 (1938). The law is clear that one "who undertakes to make statements under circumstances such as this, is bound not only to state truly what he tells, but also not to suppress or conceal any facts within his knowledge which materially qualify those statements." *Mid-States Insurance Co.* v. *American Fidelity & Casualty Co.*, 234 F.2d 721, 729 (9th Cir. 1956).

Both "Section 17(a)(2) of the Securities Act of 1933, as well as Rule 10b-5(2), are specifically aimed at half-truths, as distinct from complete omissions." *Trussel* v. *United Underwriters, Ltd.*, 228 F. Supp. 757, 762 (D. Col. 1964).[8] A comparable mix of misrepresentations and half-truths resulted in liability under these provisions in *Lehigh Valley Trust Co.* v. *Central National Bank*, 409 F. 2d 989 (5th Cir. 1969). There in connection with the sale of a participation interest in a bank loan, the selling bank informed the purchaser that the client company "was sound," was a "good customer of our bank," and generally "was all right," but failed to reveal material facts which significantly qualified the statements made. *Id.* at 990. Rejecting the bank's argument that "it made no misrepresentations of material facts," the Fifth Circuit held the bank liable under Section 10(b) for providing a misleading report because the bank "clearly failed to inform Lehigh Trust of several facts and misinformed it as to others," including "the fact that the proceeds of the participation loan were to be used to 'bail out' the earlier uncollectible loans to" its client. *Id.* at 993; *see Bowman & Bourdon, Inc.* v. *Rohr*, 296 F. Supp. 847, 851 (D. Mass. 1969).

C. Citibank's Knowledge of the Misstated and Concealed Facts Establishes Scienter

Having found that Citibank had actual knowledge of Topper's several and severe financial problems, that a

[8] *See List* v. *Fashion Park, Inc.*, 340 F.2d 457, 462 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965); III L. Loss, *Securities Regulation* 1439 (2d ed. 1961).

senior Citibank officer misstated and omitted those facts in its report to the Pension Fund, and that the Pension Fund and Connecticut Mutual in fact relied upon the favorable Citibank report (Fdg P22), the District Court's decision, if it considered the knowing misrepresentation issue at all,[9] apparently turned on holding that Citibank lacked the scienter required for liability under the federal securities laws. Thus the District Court concluded that "Waldman acted in good faith in his conversation with Thompson" and that neither Waldman nor Citibank "had any conceivable motive to mislead Thompson or the Fund" (A27-A28).

Assuming these findings relate to the question of scienter, the Court's decision raises a simple issue of law—*i.e.*, what operative facts must a plaintiff establish to meet the scienter requirement reaffirmed in *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976)? Is actual knowledge of the material facts misstated or omitted sufficient, or in addition is some showing of evil motive or wicked intent required?

Hochfelder reaffirmed that negligence alone was insufficient for liability under Section 10(b) and made clear that it intended no radical departures from accepted doctrines of securities fraud. *See McLean* v. *Alexander*, 420 F. Supp. 1057, 1080-81 (D. Del. 1976). Therefore, whatever its impact on other circuits may have been, *Hochfelder* left undisturbed the rule followed in this Circuit for some years, namely that scienter is required in private actions under the securities laws and is proved when "plaintiff has established that defendant . . . knew the material facts that were misstated or omitted. . . ." *Cohen* v. *Franchard Corp.*, 478 F.2d 115, 123 (2d Cir.), *cert. denied*, 414 U.S. 857 (1973). "[W]hether the scienter test ultimately applied be strict or liberal," proof "of actual knowledge of falsity is amply sufficient. . . ." *Heit* v. *Weitzen*, 402 F.2d 909, 914 (2d Cir. 1968), *cert. denied*, 395 U.S. 903 (1969); *see SEC* v. *Universal Major Industries*

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[9] Because there was no explanation of its legal significance, it is unclear whether the "good faith" finding is addressed to the question of scienter. At several points the Court appeared to say that "good faith" means the absence of negligence. *See* A1535-A1536.

Corp., [Current] Fed. Sec. L. Rep. (CCH) ¶ 95,804 at 90,916 (2d Cir. Dec. 16, 1976); *Chris-Craft Industries, Inc.* v. *Piper Aircraft Corp.*, 480 F.2d 341, 364 (2d Cir.), *cert. denied*, 414 U.S. 910 (1973). And this is consistent with the *Hochfelder* view that Section 10(b) "was intended to proscribe *knowing or* intentional misconduct." 425 U.S. at 197 (emphasis added).

The actual knowledge test, which has been described as "a fairly strict form of *scienter*," 2 A. Bromberg, *Securities Law* § 8.4 (522) at 204.132 (1975), comports with both the common law formulation—"[a] misrepresentation in a business transaction is fraudulent if the maker . . . knows or believes the matter to be otherwise than as represented," *Restatement of Torts* § 526 (1938)—as well as that adopted in the proposed Federal Securities Code—"[a] person makes . . . a misrepresentation with 'scienter' if he . . . knows that the matter is otherwise than as represented." ALI, Proposed *Fed. Sec. Code*, T.D. No. 3 § 296AA. These formulations make sense as scienter is "merely the Latin adverb for 'knowingly.'" *Herzfeld* v. *Laventhol, Krekstein, Horwath & Horwath*, 540 F.2d 27, 33 (2d Cir. 1976).

As for any additional requirement beyond actual knowledge, *Globus* v. *Law Research Service, Inc.*, 287 F. Supp. 188, 197-98 (S.D.N.Y. 1968), *modified on other grounds*, 418 F.2d 1276 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970),[10] rejected the contention that a showing of "an intent to deceive, to cheat, and to hoodwink" was required. *Id.* at 197. This is good law because "[i]ntent to deceive in the sense of wickedness or motive to defraud is irrelevant under *Hochfelder* as it has been in deceit for almost 200 years." Haimoff, *Holmes Looks at Hochfelder and 10b-5*, 32 Bus. Law. 147, 162 (1976). As the Ninth Circuit concluded in *Mid-States Insurance Co.* v. *American Fidelity & Casualty Co.*, 234 F.2d 721, 729 (9th Cir. 1956): "'When one

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[10] On appeal, the lower court's charge on scienter in *Globus* was sustained by this Circuit when it observed that "whatever the outcome of the great debate over ordinary negligence versus scienter in private actions under 10(b) and Rule 10b-5 . . . it is clear that Judge Mansfield's instruction satisfied the scienter requirement imposed by prior cases." 418 F.2d at 1291.

deliberately makes false representations of material facts, knowing them to be untrue, the law supplies the fraudulent intent to deceive.'" *See* O. W. Holmes, *The Common Law* 324-25 (1881).

To require more than actual knowledge would result in a higher standard for civil, than is required for criminal, liability under the securities laws. Even in criminal proceedings, the Government is "not bound to show evil motive" or to prove "that defendants were wicked men with designs on anyone's purse," but rather must simply show for conviction that defendants make "a statement knowing it to be false." *United States* v. *Simon*, 425 F.2d 796, 808-09 (2d Cir. 1969), *cert. denied*, 397 U.S. 1006 (1970); *see Crane Co.* v. *Westinghouse Air Brake Co.*, 419 F.2d 787, 795 (2d Cir. 1969), *cert. denied*, 400 U.S. 822 (1970). As *Globus* observed:

> "[T]he criminal penalties visited upon one who files a false and misleading statement only require wilfulness and intentional conduct, but do not require an intent to defraud . . . To impose upon the civil plaintiff the burden of demonstrating intent to defraud when no such burden is imposed upon the Government in a related criminal case arising out of the same statement or document would create an anomalous result. Since the statutes in question, §§ 17(a) and 10(b), do not force one to this rather odd conclusion, they should not be so read." 287 F. Supp. at 198.

D. Section 17(a) Requires Only That Plaintiffs Show Actual Knowledge of the Facts Misstated or Omitted

Whatever standard of scienter may be appropriate under Section 10(b) after *Hochfelder*, Section 17(a)(2) of the Securities Act, which was not at issue there but which also affords a private right of action,[11] by its own terms outlaws material misstatements and omissions without reference to any manipulative device or contrivance, the

[11] *See Katz* v. *Amos Treat & Co.*, 411 F.2d 1046, 1055-56 & n.10 (2d Cir. 1969); *Globus* v. *Law Research Service, Inc.*, 287 F. Supp. 188, 194-95 (S.D.N.Y. 1968), *modified on other grounds*, 418 F.2d 1276 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970).

"term[s] of art" which *Hochfelder* found to be at the heart of Section 10(b). *See* 425 U.S. at 199. If these terms are read to require proof of intent to defraud, and nothing less, which seems unlikely in light of *Hochfelder*, they are plainly absent from Section 17(a)(2). *See* 15 U.S.C. § 77q(a). As a result, the *Hochfelder* admonition that each section of the securities laws should be construed "on a particularized basis," 425 U.S. at 200, mandates that no greater standard of fault be imposed by the courts under Section 17(a)(2) than was prescribed by Congress. With this result the First Circuit in *SEC* v. *World Radio Mission, Inc.*, [Current] Fed. Sec. L. Rep. (CCH) ¶ 95,751 at 90,661 n.10 (1st Cir. Nov. 4, 1976) recently agreed. Thus liability under Section 17(a)(2), an issue which the District apparently failed to consider, follows simply from a measure of what Citibank knew against what it said to the Pension Fund.

E. Citibank Is Liable to All Plaintiffs for Its False Report to the Pension Fund

Plaintiffs having established, and the District Court having found, that Citibank had actual knowledge of the adverse facts misstated and concealed, and with the elements of materiality, reliance and causation fixed,[12] liability follows as a matter of law, regardless of any inferences on good faith or motive — each is irrelevant once actual knowledge of the falsity is established.[13] Liability here extends not only to the Pension Fund, but to the other plaintiffs as well. All Connecticut Mutual and the Dallas Bank needed to show, and did show,[14] " 'was deception

[12] Causation follows as a matter of law from a finding of materiality and reliance. *See, e.g., Chasins* v. *Smith, Barney & Co.*, 438 F.2d 1167, 1172 (2d Cir. 1970).

[13] *See infra* at 39-41.

[14] The District Court found that Connecticut Mutual in fact relied upon Citibank's favorable report (Fdg P22). The Court also found that if the Pension Fund—whose presence, as the lead investor, was essential for consummation of the Private Placement—could establish its claims against Citibank under any theory, then the remaining participants, including Connecticut Mutual and the Dallas Bank, would also be entitled to recovery (A1538).

which misled [other] stockholders and that this was in fact the cause of plaintiff's claimed injury.'" *Crane Co.* v. *Westinghouse Air Brake Co.*, 419 F. 2d 787, 797 (2d Cir. 1969), *cert. denied*, 400 U.S. 822 (1970); *see Vine* v. *Beneficial Finance Co.*, 374 F.2d 627, 635 (2d Cir.), *cert. denied*, 389 U.S. 970 (1967).

II.

Apart From the Content of Its Report to the Pension Fund, Citibank's Conduct Prior to the Private Placement Gives Rise to Liability as Both a Fraudulent Course of Business and an Improper Exercise of Financial Control.

A. The Factual Background: Citibank's Authority Under the Finance Agreement and Its History of Requiring Topper to Raise Outside Capital When Its Own Collateral Was in Jeopardy

Under the Finance Agreement, Citibank had sole authority to determine the amount of funds the Banks would provide Topper for its business operations (Fdg P215). Citibank advanced funds based upon the amount of receivables which it deemed eligible for advances, less such reserves as were necessary to protect its collateral (*id.*). Citibank exercised its authority over the years to deny Topper funds, to which it would otherwise be entitled under the Finance Agreement, by declaring certain categories of receivables ineligible for advances or creating reserves for returns and other concessions (Fdg P216).

From the outset of its relationship with Topper, Citibank required Topper to raise additional and subordinate financing whenever it viewed its own collateral insufficient (Fdg P221). On at least three occasions between 1967 and 1969, Citibank as a condition to continued financing required Topper to raise outside capital subordinate to its own loan (Fdgs P221-P223), generally from insiders (*id.*). Citibank's influence over Topper's ability to raise outside funds during this period also took the form of agreeing

or not agreeing to advance funds to tide Topper over until anticipated financings were completed (Fdgs P226-P-228).

To a significant extent it was Citibank's actions in 1971 that contributed to Topper's need to raise additional amounts of outside capital when it declared at least nine separate categories of receivables ineligible for advances (Fdg P216). It was when Topper learned that these receivables would be ineligible for advances[15] that it upped the anticipated financings in 1971 from $3 million at the end of January (Fdg P161) to more than $18 million by mid-April (Fdg P172).

B. Citibank's Management of the Topper Loan Coupled With Its Failure to Disclose Constitutes a Fraudulent Course of Business

Both Section 17(a)(3) and Rule 10b-5(3) make it unlawful for any person to engage in any "course of business which operates or would operate as a fraud or deceit upon" any person. *E.g.*, 15 U.S.C. § 77q(a)(3). Common to the cases predicating liability on a course of business, as opposed to a misrepresentation, is some form of conduct by the defendant which either facilitates or promotes the securities transaction at issue coupled with some form of inaction—generally a failure to disclose—which lulls the plaintiff into his purchase or sale. *See, e.g., Buttrey* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 410 F.2d 135, 144 (7th Cir.), *cert. denied*, 396 U.S. 838 (1969); *SEC* v. *R.J. Allen & Associates, Inc.*, 386 F. Supp. 866, 876-77 (S.D. Fla. 1974); *Reube* v. *Pharmacodynamics, Inc.*, 348 F. Supp. 900, 915 (E.D. Pa. 1972).

Although Citibank substantially contributed to Topper's need for outside capital in early spring 1971, its actions prior to the series of meetings with Topper management in mid-summer were consistent with its role as a secured lender, particularly in light of the growing jeopardy to its own collateral. If nothing else occurred, this action would not lie.

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[15] *See* Fdgs P101-P105, P283-P284.

But Citibank did more here. By requiring Topper to raise funds on an unsecured basis when it knew those funds could not, in light of the financial crisis at hand, be prudently advanced on a secured basis, Citibank set in motion, and perhaps made inevitable, the fraudulent misstatements and concealments which ultimately ensued on the part of Topper management. More than that, Citibank itself participated in the concealment by giving a favorable report to the lead investor in the financing without disclosing the facts it knew which made up the "several and severe financial problems" at Topper (Fdg P193). Taken together with the receipt of a substantial benefit,[16] these actions result in liability. As the Seventh Circuit remarked in *Buttrey* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 410 F.2d 135, 144 (7th Cir.), *cert. denied*, 396 U.S. 838 (1969), the "defendant benefited by a course of business which operated as a fraud" upon plaintiffs.

C. Citibank Is Liable as a Controlling Person

The same facts give rise to secondary liability as a "controlling person" under Section 15 of the Securities Act of 1933, 15 U.S.C. § 77o, and Section 20(a) of the Exchange Act, 15 U.S.C. § 78t(a). The SEC has long adopted a broad, fact-oriented view of the control provisions, *see Thompson Ross Securities Co.*, 6 S.E.C. 1111, 1119 (1940), and federal courts have not hesitated to do likewise.[17] Thus the Eighth Circuit in *Myzel* v. *Fields*, 386 F.2d 718, 738 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968), held that the statute requires "only some indirect means of discipline or influence short of actual direction to hold a 'controlling person' liable." Similarly, *Harriman* v. *E. I. DuPont De Nemours & Co.*, 372 F. Supp. 101, 105 (D. Del. 1974), held that control was not limited to management or shareholder relationships, but "may arise from other business relation-

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[16] *See infra* at 35-36.

[17] *See, e.g., SEC* v. *First Securities Co. of Chicago*, 463 F.2d 981 (7th Cir.), *cert. denied*, 409 U.S. 880 (1972); *Jezarian* v. *Csapo*, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,795 (S.D.N.Y. 1973); *Moerman* v. *Zipco, Inc.*, 302 F. Supp. 439 (E.D.N.Y. 1969), *aff'd*, 422 F.2d 871 (2d Cir. 1970).

ships, interlocking directors, family relationships and a myriad of other factors."

Rejecting plaintiffs' claim of secondary liability, the District Court concluded that Citibank exercised no control over Topper's sales and marketing policies (A29-A31; *see* Fdgs D18-D23), was not directly involved in the solicitation or sale of the Private Placement (Fdgs D29-D38), and had no reason to suspect that Topper was perpetrating a fraud on plaintiffs (Fdg D39).

At the outset, the District Court's finding that Citibank exercised no control over the sales and marketing practices of Topper is immaterial: Control over an issuer's financial policies, which the Court did find, suffices here. It is now recognized that one "business relationship" giving rise to the type of "indirect means of discipline or influence" required is that of a dominant creditor, particularly a bank.[18] It "is well known that one of the most powerful and effective methods of control of any business, organization, or institution . . . is the control of its finances." *Heitmeyer* v. *FCC*, 95 F. 2d 91, 99 (D.C. Cir. 1937).

As far as the absence of any overt efforts on the part of Citibank in soliciting the Private Placement is concerned, this conclusion, apart from ignoring the favorable report rendered to the Pension Fund, is beside the point because "the participation of a controlling person in the transaction . . . is not relevant to liability. . . ." *Harriman* v. *E. I. DuPont De Nemours & Co.*, 372 F. Supp. 101, 105 (D. Del. 1974). Citibank's liability as a controlling person arises "in connection with an agreement," 15 U.S.C. § 77o, under which Citibank controlled the amount of funds available to Topper (Fdg P215) and required Topper, whenever its own collateral was in jeopardy, to raise outside capital subordinate to the bank loan (Fdgs P221-P223).[19] Citibank ex-

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[18] *Cf. Chicago Corp.*, 28 S.E.C. 463 (1948); *Toolco-Northeast Control Case*, 42 C.A.B. 822 (1965); *Transocean-Atlas Case, Control and Interlocking Relationships*, 29 C.A.B. 622 (1959); A.A. Berle & G. Means, *The Modern Corporation and Private Property* 69-70 (1932).

[19] *See* A2088-A2090; A2164-A2165; A2181-A2194.

ercised this power in the summer of 1971 when it conditioned its financing on the successful completion of the Private Placement. Citibank then ensured the success of the Private Placement by providing plaintiffs with the type of assurances necessary to consummate the deal. For this reason Citibank was "'in some meaningful sense [a] culpable participant in the fraud perpetrated by [the] controlled person,'" *Gordon* v. *Burr*, 506 F.2d 1080, 1085 (2d Cir. 1974), thus distinguishing its actions here from the "grist of the mill" authority which other secured lenders routinely exercise over their clients' funding. *See Woodward* v. *Metro Bank*, 522 F.2d 84, 97 (5th Cir. 1975).

Finally in error is the Court's finding that "[n]either the Bank nor any of its officers or employees either knew or had reason to know of any misrepresentation that Topper may have made to the Fund or to any other plaintiff" (A28). Even with a first security interest in Topper assets, Citibank refused to advance the same funds on a secured basis which plaintiffs were considering advancing on an unsecured basis. The presumption is irresistible under these circumstances, particularly in light of Citibank's knowledge of the investment policies and procedures of the Pension Fund,[20] that Citibank had to have been aware that Topper's difficulties were being concealed from plaintiffs. Citibank's knowledge of Topper's fraud was not dependent on presumption alone, however, because at least two Citibank officers discussed the misleading April 29, 1971 prospectus distributed to plaintiffs prior to the Private Placement (Fdg P303)[21] and, more significantly, the questions asked by the Pension Fund made it clear that the Pension Fund was not fully apprised of Topper's true financial state.[22]

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[20] *See infra* at 54-56.

[21] Before adopting this finding, the District Court remarked: "If [Siegel] discussed [the prospectus] with Lusk then there is evidence that the bank knew it" (A1555).

[22] Thus after stating that the Pension Fund "had no experience in investing in the toy industry" (A626), Thompson proceeded to ask Waldman how Topper had performed in the audit of its receivables (A629-A630) and whether there were "any current problems in Topper" (A636-A637).

III.

Citibank Had an Affirmative Duty of Disclosure Under the Special Circumstances at Bar.

As a result of its relationship with the Pension Fund, Topper and the Private Placement, Citibank was obliged, once it agreed to speak at all, not only to refrain from making material misstatements, but also to disclose the material facts it knew evidencing the financial crisis at Topper. While a lender has no general obligation to impart information to those who buy or sell its client's securities, here there were "special facts which took them out of the general rule" and made it "the plain duty of the defendant to speak." *Strong* v. *Repide*, 213 U.S. 419, 431 (1909); *see Affiliated Ute Citizens* v. *United States,* 406 U.S. 128, 152-53 (1972).

A. Citibank Undertook to Provide Information About Topper

The District Court found that on August 25, 1971 a representative of the Pension Fund telephoned the liaison officer at Citibank responsible for the Pension Fund account and asked for whatever information Citibank could provide to evaluate the Private Placement (Fdgs P299, P305-P307). Following that initial call, the liaison officer, who was not personally familiar with the Topper account, requested that Mr. Waldman, who was, telephone the Pension Fund (Fdg P305).

It is thus clear, particularly since Citibank disavows any obligation under the 1950 agreement,[23] that the bank voluntarily agreed to provide the Pension Fund with information about Topper, an undertaking which gives rise to an affirmative duty of disclosure. Once Citibank agreed to say anything about its Topper account, it was then obliged to reveal all material facts within its possession. " 'If he speaks at all, he must make a full and fair disclosure.' " *Mid-States Insurance Co.* v. *American Fidelity & Casualty Co.,* 234 F. 2d 721, 729 (9th Cir. 1956); *see Bowman & Bourdon,*

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[23] *See* Fdg D281.

Inc. v. *Rohr*, 296 F. Supp. 847, 851 (D. Mass. 1969). It is hornbook law that while

> "in the absence of special circumstances, there is no duty imposed upon one party to a transaction to speak for the information of the other, nevertheless if he does speak with reference to a given point of information, voluntarily or at the other's request, he is bound to speak honestly and to divulge all the material facts bearing upon the point that lies within his knowledge." F. Harper & F. James, *The Law of Torts* § 7.14 at 586 (1956).

"This is particularly true where one party to a deal, though in no sense a fiduciary, is possessed of superior knowledge as to facts material and important to the transaction which he fails to disclose to the other party." *Anderson* v. *Knox*, 297 F. 2d 702, 727 (9th Cir. 1961), *cert. denied*, 370 U.S. 915 (1962).

B. Citibank Possessed Inside Information About Topper's Financial Condition

Another well-recognized basis for imposing an affirmative duty of disclosure grows out of an insider's relationship with the issuer. "[T]hose persons who are in a special relationship with a company and privy to its internal affairs . . . thereby suffer correlative duties" in the purchase and sale of its securities. *Cady, Roberts & Co.*, 40 S.E.C. 907, 912 (1961); *see Myzel* v. *Fields*, 386 F. 2d 718, 739 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968). "In determining whether a person, not a director or officer, is a corporate insider . . . the test is whether he had such a relationship to the corporation that he had access to information which should be used 'only for a corporate purpose and not for the personal benefit of anyone.'" *Ross* v. *Licht*, 263 F. Supp. 395, 409 (S.D.N.Y. 1967).

As Topper's lead commercial banker, Citibank had access to, and possession of, information relating to Topper's financial condition unavailable to the investing public (Fdgs P210-P214) and, accordingly, was an insider under

the securities laws.[24] As such, Citibank was obliged either to disclose fully its inside information or to abstain fully from making any "assertions . . . reasonably calculated to influence the investing public. . . ." *SEC* v. *Texas Gulf Sulphur Co.,* 401 F.2d 833, 848, 862 (2d Cir. 1968), *cert. denied,* 394 U.S. 976 (1969). This "applies whether the securities are traded on a public stock exchange or sold through private placement." *Radiation Dynamics, Inc.* v. *Goldmuntz,* 464 F. 2d 876, 887 (2d Cir. 1972). And there is "no necessity for contemporaneous trading in securities by insiders" for the obligation to arise, *Heit* v. *Weitzen,* 402 F. 2d 909, 913 (2d Cir. 1968), *cert. denied,* 395 U.S. 903 (1969), although Citibank could be considered an indirect seller here because the proceeds were earmarked for its account.

C. Citibank Benefited Financially From the Private Placement

"[T]he factor of gain is an important, if not dispositive, consideration," *Fischer* v. *Kletz,* 266 F. Supp. 180, 190 (S.D.N.Y. 1967), in determining whether an affirmative duty of disclosure exists. As the Ninth Circuit remarked, principal among the factors in determining "the scope of the duty imposed" by Rule 10b-5 is "the benefit that the defendant derives from" the securities transaction to which his conduct related. *White* v. *Abrams,* 495 F.2d 724, 731, 735-36 (9th Cir. 1974); *see* 2 A. Bromberg, *Securities Law* § 8.5 (584) at 208.46-49 (1975).

Finding that both a bank and its officers, who neither bought nor sold the securities at issue, still had an "affirmative duty under the Rule to disclose," 406 U.S. 128, 153 (1972), *Affiliated Ute Citizens* v. *United States* emphasized the fact that the defendants were in a position "to gain financially from" the sales (*id.*) and emphasized the benefit which the bank reaped in "increased deposits because of the development of this market." *Id.* at 152. And "in *Texas*

[24] "The prudent commercial lender is apt to know as much about the inner affairs of his actual or potential borrowers as many members of the borrower's corporate family." Harfield, *Texas Gulf Sulphur and Bank Internal Procedures Between the Trust and Commercial Departments,* 86 Banking L.J. 869, 873 (1969).

Gulf Sulphur the decision was based upon a failure properly to disclose . . . and the reaping thereby of substantial financial benefits by certain defendants." *Lanza* v. *Drexel & Co.*, 479 F. 2d 1277, 1302 (2d Cir. 1973); *see Crane Co.* v. *Westinghouse Air Brake Co.*, 419 F.2d 787, 795 (2d Cir. 1969), *cert. denied*, 400 U.S. 822 (1970). Such case law does no more than track the hornbook rule[25] that "a duty [is] imposed where [there] is . . . some actual or potential economic advantage to the defendant, and the expected benefit justifies the requirement of special obligations." W. Prosser, *Torts* § 56 at 339 (4th ed. 1971).

Here the benefit to Citibank was two-fold: *First*, pursuant to its previous arrangement with Topper management, on the day following the Private Placement the entire proceeds of the Private Placement were remitted to Citibank for its own benefit and as agent for other secured lenders under the agreement (Fdg P293). Apart from the form of this transaction, Citibank was the true beneficiary of the Private Placement (Fdg P296) since plaintiffs' money enabled the bank to substantially reduce the amount of its own capital committed to this crisis-laden operation (Fdg P295). As a Citibank audit report remarked shortly after the close of the Private Placement, it was "[g]ood to see our loan down" (A3236).

Second, the Private Placement accomplished more for Citibank than simply cutting its potential for loss. By adding more than $5 million in working capital which was required by Topper to carry on its day-to-day business, the Private Placement enhanced, at least temporarily, whatever chance Mr. Waldman's largest account had of making it through the 1971 Christmas season. What this meant for Citibank, who acted as agent for other secured lenders (Fdg P51), was an opportunity to continue to earn substantial

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[25] If there is "any single consistent principle which can be found running through the apparently amorphous mass of affirmative duties in the law of torts . . . [t]he binding thread seems to be a *benefit principle*. . . . The greater the benefit likely to accrue, the more extensive is the duty." McNiece & Thornton, *Affirmative Duties in Tort*, 58 Yale L.J. 1272, 1282-84 (1949).

fees for servicing the Topper account but at substantially reduced risk[26] (Fdg P55).

The District Court concluded "that any benefit the Bank may have gained from the use of the private placement to reduce its outstanding balances was quickly dissipated by new loans made in a continuing course of business" (A29). Implicit in this statement, of course, is the recognition that Citibank did in fact benefit from the Private Placement. Whether Citibank's own actions, taken after plaintiffs' investment, dissipated the benefit received is irrelevant—the fact remains that Citibank did benefit from plaintiffs' investment, and it is that benefit, not its subsequent diminution, which gives rise to the affirmative duty. In fact the $3 million loss which Citibank subsequently suffered with the Topper account occurred as a result of advances made in 1972 and 1973 when Topper was in reorganization (A1335).

D. Citibank Played a Substantial Role in Making the Private Placement Possible

Citibank's activity in connection with the Private Placement, taken together with the possession of inside information and the benefits it reaped, provide a further ground for imposing an affirmative duty of disclosure. *See Affiliated Ute Citizens* v. *United States,* 406 U.S. 128, 151-53 (1972); *White* v. *Abrams,* 495 F.2d 724, 731 (9th Cir. 1974).

Initially, Citibank made the Private Placement possible by agreeing on three separate occasions during the summer of 1971 to extend the bridge financing which was necessary to see Topper through until the Private Placement (Fdgs P275, P281, P288). Without these bridge loans, the District Court found, Topper would not have survived until the Private Placement as a going concern (Fdgs P188, P191,

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[26] For managing the Topper account, Citibank retained as compensation the balance of income received from the Topper loan which was not remitted to other participants (Fdg P53). As a result of these arrangements, the yield to Citibank from its investment was considerably in excess of the interest rate charged Topper (Fdgs P53, P56), and ran at times "in excess of 13%" (A3265).

P193).[27] Equally significant, Citibank conditioned these bridge loans on the successful completion of the Private Placement, a requirement which the District Court itself recognized gave rise to some affirmative duty (*see* A1610, A1623).

Citibank further enhanced the Private Placement by providing a favorable report on Topper's current financial condition which the Pension Fund and Connecticut Mutual relied upon to their detriment (Fdg P22). A similar pattern of encouraging or promoting a securities transaction while possessing negative information on the issuer was deemed sufficient to give rise to an affirmative duty of disclosure in *Fischer* v. *New York Stock Exchange*, 408 F. Supp. 745, 751 (S.D.N.Y. 1976), *rev'd on other grounds sub nom. Lank* v. *New York Stock Exchange*, No. 76-7243 (2d Cir. Jan. 20, 1977).[28]

E. Citibank's Special Relationship With the Pension Fund

A final reason for imposing an affirmative duty on Citibank is the 20-year relationship between the parties growing out of Citibank's 1950 undertaking to provide investment advisory services to the Pension Fund. In discharging its contractual duties, Citibank periodically discussed investment policy on publicly traded securities (Fdg D275) with the Pension Fund and, in addition, over the years provided the Pension Fund with information about corporations which had lending arrangements with the bank, in connection with private placements that the Pension Fund was considering (Fdgs D276-D279).

As a result of the 1950 agreement and the pattern and practice which developed under that agreement,[29] a relationship arose between the Pension Fund and Citibank,

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[27] Topper's only other potential source of bank financing, Manufacturers Hanover Trust Company, which received weekly reports on Topper's receivables and collection difficulties throughout the summer (Fdg P214), had already refused to take over the Topper loan in early June (A2138).

[28] In reversing the District Court's decision, *Lank* reaffirmed the existence of an affirmative duty of disclosure owed by the Exchange, but held that the duty ran to investors, not to Exchange members.

[29] *See infra* at 53-56.

akin to that of a fiduciary,[30] with respect to the investment services for which Citibank allocated $20,000 to $25,000 of its annual charges to the Pension Fund each year (A1672). *See Consolidated Oil & Gas, Inc.* v. *Ryan,* 250 F.Supp. 600, 607 (W.D. Ark.), *aff'd,* 368 F.2d 177 (8th Cir. 1966). Having gained the confidence of the Pension Fund (A831-A833), Citibank "may not escape responsibility for its abuse by invoking a rule applicable between strangers." *Kershaw* v. *Julien,* 72 F.2d 528, 530 (10th Cir. 1934). When "a state of confidence exists, it is the duty of him in whom the confidence is reposed to disclose every material fact within his knowledge. . . . When there is a duty to speak, the suppression of the truth is as reprehensible and as actionable as the utterance of the false." *Id.; see Meinhard* v. *Salmon,* 249 N.Y. 458, 464, 164 N.E. 545, 546 (1928); *Restatement of Torts* § 551 (1938).

F. The Special Circumstances at Bar Give Rise to an Affirmative Duty

Viewed separately, each of these special circumstances[31] provides an independent basis for imposing an affirmative duty of disclosure on Citibank. But if any alone is insufficient, "the existence of all the others in addition making such a combination as rendered it the plain duty of the defendant to speak." *Strong* v. *Repide,* 213 U.S. 419, 431 (1909). As the Supreme Court concluded, "The case before us seems a plain one for holding that, under the circumstances detailed, there was a legal obligation on the part of the defendant to make these disclosures." 213 U.S. at 434. For its failure to do so, Citibank is liable to all plaintiffs.

[30] Under New York law, "[a] fiduciary relationship is one founded on trust or confidence reposed by one person in the integrity and fidelity of another. . . . The rule embraces both technical fiduciary relations and those informal relations which exist whenever one man trusts in and relies upon another." *Mobil Oil Corp.* v. *Rubenfeld,* 72 Misc. 2d 392, 399-400, 339 N.Y.S.2d 623 (Civ. Ct. 1972), *aff'd,* 77 Misc. 2d 962, 357 N.Y.S.2d 589 (App. Term 1974), *rev'd on other grounds,* 48 App. Div. 2d 428, 370 N.Y.S.2d 943 (2d Dep't 1975), *aff'd,* 40 N.Y.2d 936 (1976); *see Penato* v. *George,* 52 App. Div. 2d 939, 942, 383 N.Y.S.2d 900, 904-05 (2d Dep't 1976).

[31] *See SEC* v. *Texas Gulf Sulphur Co.,* 401 F.2d 833, 848 (2d Cir. 1968), *cert. denied,* 394 U.S. 976 (1969); *Charles Hughes & Co.* v. *SEC,* 139 F.2d 434, 437 (2d Cir. 1943), *cert. denied,* 321 U.S. 786 (1944).

IV.

The District Court's Finding That Waldman Acted in Good Faith Was Induced by an Erroneous View of the Law and Was Contrary to the Great Weight of More Probative Evidence.

A. The "Good Faith" Finding Was Induced by an Erroneous View of the Law

In reaching its good faith[32] finding, the District Court analyzed the evidence "[o]n the question of comparative negligence" (A1531) and concluded that Waldman acted in accord with prevailing "standards in the community" of secured lenders (A1532). In so doing, the Court was induced by an erroneous view of the law. If *Hochfelder* makes anything clear, it is that a negligence analysis has no place under Section 10(b). *See Holdsworth* v. *Strong,* [Current] Fed. Sec. L. Rep. (CCH) ¶ 95,744 at 90,605 (10th Cir. July 8, 1976). As *McLean* v. *Alexander,* 420 F. Supp. 1057, 1081 (D. Del. 1976) pointed out: "Since a good faith defense is appropriate only in negligence actions, one may conclude that Congress intended 10b to govern reckless, knowing, or deliberate conduct, none of which are negatived by the defense of good faith."

Once actual knowledge of the facts misstated or omitted is established, good faith is irrelevant.[33] Or, as Holmes observed, it is of no consequence whether a person "believes his statement or not." O. W. Holmes, *The Common Law* 325 (1881). For this reason *SEC* v. *Texas Gulf Sulphur Co.,* 401 F.2d 833, 862 (2d Cir. 1968), *cert. denied,* 394 U.S. 976 (1969), rejected good faith as a defense under Rule 10b-5 once plaintiffs establish that the assertions made "are false or misleading or are so incomplete as to mislead. . . ." [34]

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[32] Good faith has been appropriately described as a term "equally elusive" as its opposite, bad faith, and both "remain cherished resorts of lawyers (and sometimes of judges) who have little else to conjure with." 2 A. Bromberg, *Securities Law* § 8.4 (561) at 204.204 (1975).

[33] *See supra* at 22-26.

[34] *Texas Gulf Sulphur* held that good faith was an adequate defense only if the defendant "demonstrates that it was diligent in ascer-

Stated otherwise, "[i]f actual knowledge is found, good faith is of course negated." Bucklo, *Scienter and Rule 10b-5*, 67 Nw. U.L. Rev. 562, 570 n.35 (1972). If anything, good faith means nothing more than disclosing to "the plaintiff the facts bearing upon or which might affect the value of the stock." *Strong* v. *Repide*, 213 U.S. 419, 430-31 (1909); *see Bowman & Bourdon, Inc.* v. *Rohr*, 296 F. Supp. 847, 851 (D. Mass. 1969).

Apart from applying an improper standard of fault, the Court's reference to the prevailing practices in the banking industry in determining Waldman's good faith (A1532) was equally in error. As *Sanders* v. *John Nuveen & Co.*, 524 F.2d 1064, 1071 (7th Cir. 1975), *vacated on other grounds*, 44 U.S.L.W. 3592 (U.S. Apr. 19, 1976) observed:

> "[T]he fact that their practices may have been considered acceptable by the banking industry would not convince us that they meet the standards imposed by the relevant statutes and regulations."

The type of banking practice at issue here is illustrated by the testimony of Citibank's Mr. Siegel who, when asked "what was the credit of Topper during the period," responded, "I will give you an answer we give our inquirers; it was satisfactory" (A1291).[35] The inadequacy of this response is clear from Siegel's own admission that "he and his associates" were "concerned about their position" prior to the Private Placement (A1501-A1502).[36]

The securities laws required much more from Citibank than routine adherence to trade practices. *See Chasins* v.

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taining that the information it published was the whole truth and that such diligently obtained information was disseminated in good faith. . . ." 401 F.2d at 862. Such a defense is plainly lacking here because Waldman admits he knew all the material facts but failed to disclose them. *See infra* at 45-46.

[35] Citibank officers testified that from time to time they received "credit inquiries made to the bank concerning Topper" (A1166; A1281-A1282). These inquiries, according to Messrs. Lusk and Siegel, generally emanated from suppliers, such as "an automobile leasing company," who were apparently interested in Topper's payable record (A1166).

[36] *See infra* at 50-52.

Smith, Barney & Co., 438 F.2d 1167, 1171 (2d Cir. 1970). Once Citibank agreed to speak, it was obliged to disclose those facts *which a reasonable investor* would deem material. *See TSC Industries, Inc.* v. *Northway, Inc.*, 44 U.S.L.W. 4852, 4854 (U.S. June 14, 1976). It is this issue of disclosure under the securities laws, not Citibank's conduct in the community of secured lenders (A1532), nor what Waldman would have told a bank superior (A1536), that controls. For this reason, whether Topper was a "good credit" from the point of view of a secured lender, which the District Court found persuasive, is immaterial because, as Waldman and Citibank knew, the Pension Fund as a potential investor in unsecured Topper notes wanted "all the information necessary" to evaluate that form of investment (Fdg P307).[37]

B. Citibank Is Estopped From Asserting a "Good Faith" Defense

Even were good faith deemed a proper defense, it would be unavailable to Citibank. At the outset, it is not disputed by the parties, the clearly erroneous observation of the District Court notwithstanding,[38] that the Pension Fund requested information concerning Topper from *Citibank*, not Mr. Waldman, and that it was the Citibank liaison officer

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[37] The status of Topper as a secured credit relates simply to the ability of Citibank to recover its loan in bankruptcy, and not to the issue of financial problems *per se*. Underscoring the distinction between a "good credit" to a secured lender and the type of financial problems relevant to an unsecured investor was the fact that Citibank and other secured lenders continued to advance funds to Topper in 1972, well beyond the time of Topper's public announcement of its financial difficulties (A1335; A3198).

[38] The District Court rejected "as incredible" an essentially undisputed finding that the Pension Fund "decided to have Thompson call Jeffers and ask his unguided advice as to the best Citibank person to consult with respect to investing in Topper" (A26 n.5). The Court's inference was clearly erroneous because Citibank itself proposed a finding, which the Court rejected, that "Jeffers . . . asked Thompson for his phone number and said that *someone* would get back to him" (*see supra* at 15 n.5; emphasis added). And counsel for Citibank stated at trial that "[t]he record will show that Mr. Thompson called Mr. Jeffers and said, 'Can you put me in touch with *somebody* at the bank who has information on Topper'" (A1351-A1352; emphasis added). The Court itself acknowledged at the close of trial that it was in error on this point (A1569).

to the Pension Fund, not plaintiffs, who selected Waldman to respond to this request. Nor is it disputed that the Citibank officer in charge of the Topper account on a daily basis was seriously concerned about Topper's financial condition.[39] The Court itself acknowledged that the evidence suggested quite clearly that had Mr. Siegel rather than Mr. Waldman spoken to the Pension Fund, "an entirely different result might have followed" (A1526).

Under these circumstances, Citibank is estopped from pleading the good faith of the individual officer it selected to respond to the Pension Fund's request for information, particularly when the officer selected withheld material facts which caused concern to another officer more familiar with the Topper account. As a matter of law, Citibank "is necessarily chargeable with the composite knowledge of its officers and agents acting within the scope of their authority." *Sawyer* v. *Mid-Continent Petroleum Corp.*, 236 F. 2d 518, 520 (10th Cir. 1956); *see Copeman Laboratories Co.* v. *General Motors Corp.*, 36 F. Supp. 755, 762 (E.D. Mich. 1941). As was said in a related context, "it was incumbent upon [Citibank] to select an agent to answer . . . who could provide the information sought by the" Pension Fund. *Holt* v. *Southern Railway*, 51 F.R.D. 296, 299-300 (E.D. Tenn. 1969).

In holding that plaintiffs must bear the burden of a misleading report which resulted from Citibank's decision to choose one employee over another, the District Court erred because Citibank was estopped from asserting this defense against those who "in good faith relied upon such conduct, and has been led thereby to change his position for the worse. . . ." 3 J. Pomeroy, *Equity Jurisprudence* § 804 at 189 (5th ed. 1941). The rule of estoppel is invoked to prevent a person "from taking an inequitable advantage of a predicament in which his own conduct had placed his adversary." W. Prosser, *Torts* § 105 at 691 (4th ed. 1971). It applies even where the act giving rise to the estoppel—here the selection of Waldman instead of Siegel—was performed without scienter or intent to deceive. *See Continental National Bank* v. *National Bank of the Common-*

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[39] *See infra* at 50-52.

wealth, 50 N.Y. 575, 583 (1872); *Leather Manufacturers' Bank* v. *Morgan,* 117 U.S. 96, 108 (1886).

C. In Any Event, the Good Faith Finding Was Clearly Erroneous

Apart from being induced by an erroneous view of the law, the District Court's finding that Waldman acted in good faith when he gave a favorable report on Topper's current financial condition was clear error. At the outset, the good faith "conclusion" (A1536) was a secondary or derivative inference drawn from a variety of evidence adduced at trial. As such, it may be disregarded on appeal, even though it relates to a state of mind,[40] if other more rational deductions can be drawn from the same evidence, and must be disregarded "when the derivative inference either is not rational or has but a flimsy foundation in the testimony." *American Tobacco Co.* v. *The Katingo Hadjipatera,* 194 F.2d 449, 451 (2d Cir. 1951), *cert. denied,* 343 U.S. 978 (1952).

Since "[d]irect evidence is rarely available to prove" intention, it "must be inferred from the facts and circumstances of the situation in question." *Marshall* v. *United States,* 146 F.2d 618, 620 (9th Cir. 1944). Relevant to any inference that Waldman acted in good faith when he gave his favorable report to the Pension Fund are several categories of evidence, some more probative than others. In drawing its good faith inference, the District Court erred as a matter of law in weighing certain categories, such as testimonial and demeanor evidence, more heavily than other more probative forms of proof.

The rule is settled that "when oral testimony is contradicted by contemporaneous documents, the trier of fact should give little weight to the oral testimony." *United States* v. *IBM Corp.,* 66 F.R.D. 154, 159 (S.D.N.Y. 1974). For this reason, "[w]here the evidence is partly oral and the balance is written or deals with undisputed facts," an

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[40] *See Orvis* v. *Higgins,* 180 F.2d 537, 540-41 (2d Cir.), *cert. denied,* 340 U.S. 810 (1950); *E.F. Drew & Co.* v. *Reinhard,* 170 F.2d 679, 683-84 (2d Cir. 1948).

appellate court may ignore the trial judge's findings and substitute its own "if the written evidence or some undisputed fact renders the credibility of the oral testimony extremely doubtful. . . ." *Orvis* v. *Higgins,* 180 F.2d 537, 539 (2d Cir.), *cert. denied,* 340 U.S. 810 (1950). This is true "[d]espite the opportunity of the trial court to appraise the credibility of the witnesses." *United States* v. *United States Gypsum Co.,* 333 U.S. 364, 396 (1948).

Even less reliable is the oral testimony of an interested party. As this Circuit held in *United States ex rel. Brennan* v. *Fay,* 353 F.2d 56, 59 (2d Cir. 1965), when one party presents "probative documentary evidence, only the strongest contrary oral testimony could prevail, especially when proffered by an interested party as to occurrences of long ago." "Where, as here, the court must choose between contemporaneous documents or the hindsight observations of an interested witness, the court is constrained to choose the former." *United States* v. *IBM Corp.,* 66 F.R.D. 154, 175 (S.D.N.Y. 1974). *See also Richardson* v. *Commissioner,* 264 F.2d 400, 403 (4th Cir. 1959); *Ritter* v. *Rohm & Haas Co.,* 271 F. Supp. 313, 320 (S.D.N.Y. 1967).

As far as demeanor evidence is concerned, the conduct of a "person in court during the trial is too elusive to be justifiably considered as any indication whatever of his . . . consciousness." II J. Wigmore, *Evidence* § 247 at 109 (3d ed. 1940).[41] In short, in assessing the good faith of Citibank and its officer, Mr. Waldman, extrinsic evidence showing what Citibank actually did is far more reliable than what its employees, four years after the fact, say they thought.

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[41] "It may come as a shock to some of the older lawyers to be informed that modern science regards seeing the witnesses and hearing them as very little, if any, help in determining their veracity. That expert criminologist, William Shakespeare, makes Duncan say, 'There is no art to tell the mind's construction in the face.' And the psychologists agree with him. A 'shifty eye' usually means nothing but shyness. A restless manner is simply a restless manner. Hesitation indicates, as often as not, an effort to be accurate. An 'evil look' is what you see on the faces of Socrates, Darwin, and a large proportion of myopic or cross-eyed professors of law and other subjects who are relatively harmless." Blatt, *"He Saw the Witnesses",* 38 J. Am. Jud. Soc'y 86 (1954).

"Behavior rather than words among men and women is most significant in ascertaining intent." *Speed* v. *Transamerica Corp.*, 99 F. Supp. 808, 821 (D. Del. 1951), *aff'd*, 235 F.2d 369 (3d Cir. 1956). In light of this legal framework, what does the evidence disregarded by the District Court show with regard to Waldman's good faith?

1. *Waldman Initially Denies Telling the Pension Fund There Were "No Problems" at Topper*

Even though in early 1972 Waldman acknowledged giving a favorable report to the Pension Fund (Fdgs P320-P321), when this dispute later ripened into a controversy between the parties and Waldman's conduct was called into question, he refused to acknowledge this pivotal fact under oath on three occasions.[42] Thus, when asked by his own counsel on direct examination whether he recalled "*any* question relating to whether there were *any* problems in the Topper account," Waldman flatly responded, "No" (A1378). Only when faced with this issue some three hours later, and this time by the Court itself, did Waldman reverse field and admit telling Thompson, as he had acknowledged in 1972, that there were "no problems" on August 27, 1971 (A1410-A1411). This contradiction, which escaped the District Court's attention,[43] disables reliance on Waldman's testimony. "It has often been said that a prior self-contradiction shows 'a defect either in the memory or in the honesty' of the witness." IIIA J. Wigmore, *Evidence* § 1017 at 993 (Chadbourn rev. 1970).

2. *Waldman Personally Was Aware of the Material Facts Relative to Topper's Financial Crisis*

Apart from these contradictions, what Waldman admits he knew and said is "the most persuasive form of proof

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[42] Apart from direct testimony at trial, when testifying under oath before the Securities and Exchange Commission in 1973, more than two and a half years before trial, Mr. Waldman denied that Thompson asked "whether there were any problems with Topper" and stated, "I don't think we discussed problems at all" (A2359). Nor did Waldman make any mention of this fact during the course of cross-examination by plaintiffs' counsel (A1395-A1409).

[43] *See* A1410.

that exists." *B. Altman & Co. v. Lewis,* 8 Misc. 2d 802, 804, 160 N.Y.S.2d 897, 899 (App. Term 1957). Waldman admits that he knew the Pension Fund " 'wanted all the information necessary' to evaluate the Private Placement" (Fdg P307); that he was personally aware of the material facts which the Court found to comprise the several and severe financial problems at Topper (A1394-A1395; Fdg P193); that, indeed, on August 27, 1971, the very day of his favorable report to Thompson, Waldman personally reviewed and initialed the August 26th Citibank Advance Sheet which manifested the deterioration of Topper's finances (A1747; *see* PX 1442 at Addendum to this brief); and that, despite this knowledge, he still told the Pension Fund "that Topper had performed well in a Citibank audit of its receivables, that Topper's principal product line was faring well at retail, that there were no current problems with the Topper account" (Fdg P20).

These admissions, not Waldman's testimonial *ipse dixit,* constitute the most telling evidence of Waldman's true state of mind. Here as in *Mid-States Insurance Co.* v. *American Fidelity & Casualty Co.*, 234 F.2d 721, 729 (9th Cir. 1956), where a district court's failure to find fraud was reversed as clearly erroneous, the misrepresentations and omissions themselves give rise to an "irresistible" inference of bad faith.

3. *Citibank Refuses to Advance Funds on a Substantial Portion of Topper's Receivables*

Equally relevant in establishing his state of mind are the actions taken by Waldman to protect Citibank's first security interest in Topper's principal asset, the accounts receivable. Thus even though Citibank had a 20% reserve built into its lending formula to protect against "dilution" of its collateral (Fdgs P50, P98), another $15 million or so of Topper receivables was removed from the eligible collateral category by Citibank in the spring and summer of 1971.[44] As a result of these actions, by August 27, 1971 roughly 50% of Topper's receivables was deemed unworthy as collateral by Citibank (Fdg P264). This behavior, not

[44] *See* Fdgs P101-P105, P179, P182, P283-P284.

Waldman's words, is the most persuasive evidence that there was a problem with the Topper account.

4. *Citibank Conditions Further Financing on the Successful Completion of the Private Placement*

Also bearing on Waldman's good faith is the fact that Waldman himself, when asked on three occasions in the summer of 1971 for the additional financing required to maintain Topper as a going concern (Fdg P189), demanded assurances from Topper management that the funds advanced would be replaced by outside financing (Fdgs P275, P281, P288). The fact that Waldman felt it necessary to extract this condition, belies Waldman's later professed belief that all was serene with his largest account.

Equally revealing is the escalating amount of bridge financing that was necessary to keep Topper afloat until the Private Placement (Fdg P269). Bearing this out, at the July 13 and 14 meetings, Waldman took the position that in no event were over-advances to exceed the $3 million "expected to peak in the first week in August" (A2873). Yet five weeks later, two days before Waldman's call to the Pension Fund, Topper was forced to request $5 million in over-advances (Fdg P288), a sum *ten times* the amount established as permissible by Citibank in February (Fdg P269). According to Citibank's Mr. Siegel, Citibank "went along at this time" only because it knew the "debenture money" was coming in (Fdg P288).

5. *Citibank Amends the Finance Agreement to Induce Ford Motor to Participate and Thus Reduces Its Own Share of the Topper Loan*

Likewise in contrast with the picture of calm portrayed by Mr. Waldman at trial are the three amendments to the Finance Agreement which occurred in the two-month period preceding the Private Placement. In addition to the July 15 (Fdg P280) and August 25 (Fdg P288) amendments which were precipitated by Topper's request for bridge financing, on September 17, 1971 in another step which worked to reduce Citibank's financial commitment to Topper, Citibank agreed to forego its first security interest

under the Finance Agreement and permit the Ford Motor Credit Company to participate in the Topper loan on a *pari passu* basis to the full extent of its $7 million loan. This action was taken by Citibank despite its initial expression of displeasure at the proposed Ford loan early in June,[45] and even though Citibank could have prohibited this loan by refusing to let Ford Motor share in the collateral (A1369). Nonetheless, on September 17, 1971, Citibank was "willing to enter into this Amendment in order to induce" Ford Motor to make such loan to Topper (A3636). As a result of the Ford Motor loan and the Private Placement, Citibank effected a substantial reduction in its own share of the Topper loan, and a decrease in its exposure to the financial difficulties of its client. In the twelve-day period from September 17 to September 29, 1971, Citibank's share of the outstanding Topper loan was reduced from $8.5 million to $3.2 million (Fdg P295).

6. *Waldman's Explanations Are Inconsistent With Facts Known to Him and Citibank*

When asked by counsel, and then by the Court, to "explain in your own language why you didn't tell him all these things" (A1409), Waldman relied upon four separate explanations, each of which is at odds with Citibank's own contemporaneous records and actions.

(i) *Citibank Expected the Spring 1971 Program Receivables to Be Paid on Time*

Mr. Waldman initially asserted that he was not concerned about the receivables because the due dates were "really artificial in the sense that Topper was trying to ship merchandise earlier than normal" (A1410). According to an internal Citibank memorandum, however, on December 17, 1970 Waldman and other Citibank officers were told by Topper management that the purpose of the Spring 1971

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[45] According to Topper's Financial Vice President, Mr. Rose, Citibank initially was "not happy" with the Ford Motor loan because "this was the first instance where [its] collateral was being affected" (A2187).

Program was "to attract business for early 1971" (A3260).[46] Confirming this, the cash flow projection submitted by Topper to Citibank on or about January 21, 1971 (Fdg P239), which Citibank required as a condition to financing Topper and which formed the basis for Citibank's own lending plans for 1971 (Fdgs P232-P233), projected collection of these receivables during the May through September period (Fdg P175).

(ii) *Citibank's Actions Indicate It Was Not Persuaded by Orenstein's Claim That the Receivables Would Be Paid*

Mr. Waldman's next claim was that his concern over the substantial amount of past due receivables was assuaged by Orenstein's assurance that "the product was still there" and "that eventually the customers would pay when it became more normal for them to pay" (A1375). Citibank's own records, however, showed that a substantial amount of Topper merchandise was not "still there," as Waldman claimed, but instead had been credited and accepted for return (Fdg P263). Waldman's explanation is also at odds with Citibank's refusal to advance any funds against the past due receivables which Orenstein assured him would be paid (Fdgs P283-P284). Apart from refusing to lend against these receivables, a Citibank officer admitted that "great pressure was put on" Topper by Citibank in August to have these receivables paid (A3629).[47]

These steps, and not Waldman's explanation at trial, are consistent with the fact that claims of future payment afford "very little confidence" to secured lenders who routinely discount such claims (A1460). As the former president of another secured lender explained at trial, "I never

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[46] This is consistent with Orenstein's testimony that the Spring 1971 Program was designed to "promote sales . . . by . . . customers in the early part of the year" and thus even out sales throughout the year as a whole (A2076-A2077).

[47] According to this officer, "Topper had been in so many times to get their cash shortage relieved and there had been so many discussions about how the over-advances would be eliminated that Citibank now wanted some action and pressure was put on" (A1504).

had it happen where the client didn't say he was going to sell tomorrow or six months from now. That is the first thing you hear. And I hate to tell you how many times that did not happen" (*id.*).

(iii) *Topper's Financial Squeeze Stemmed From Its Customers' Failure to Pay Rather Than Increased Expenses*

Mr. Waldman's third claim was that a principal reason for the $5 million over-advance on August 27, 1971 was the fact that Topper "required more money than they had estimated" because of increased Sesame Street costs (A1376). Mr. Waldman's own records for 1971, however, showed that during the five-month period, May through September, when Topper management purportedly needed these over-advances to pay for increased Sesame Street expenses, actual operating disbursements were $3.4 million *less* than the amount projected in January (A3652). On the other hand, during the same period Topper's collections fell short of projections by more than $10.5 million (A3595). As a result, as Citibank's contemporaneous records make clear, the true cause of the over-advances was the unprecedented shortfall in collections (Fdgs P176-P177, P188), and not any increase in expenses due to Sesame Street.[48]

(iv) *The Citibank Account Executive Responsible for Topper Believed There Were Serious Problems*

In substantial measure, Mr. Waldman's justification for this favorable report to Mr. Thompson is based on his claim that "we felt, I felt, the staff felt, that this still was a good credit" (A1409). Belying this claim, the Citibank executive responsible for the Topper account on a daily basis, Mr. Siegel, admitted to a representative of Ford Motor in 1972 that "he and his associates" were "concerned about their position" prior to the Private Placement:

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[48] Confirming this, expenses actually incurred for the Sesame Street line amounted to only $385,592 according to a Topper trial balance run on August 2, 1971 (*see* A3433 at Account #187.0000; A3447 at Account #920.9800).

"The Court: Did you get any feeling . . . from his conversation what [Siegel] and his associates thought at the time these things were happening? Did they think the bank was in peril or did they not?

"The Witness: Oh, I don't think there is any question that they felt they were in a very serious position, that they were substantially over-advanced, and that they were concerned.

"Apparently there had been a series of meetings with Topper where Topper had come in and asked 'Won't you advance money against these three ineligible categories,' and apparently they had prevailed from time to time on Citibank to go ahead and make further advances.

"But as I understood it, Topper was more or less continually, continuously in violation of the formulas that had been set up, and on that basis, yes, Citibank was concerned about their position" (A1501-A1502).

According to Mr. Siegel, Citibank's concern with the Topper account began with the cash shortage in the latter part of 1970 (A1491), continued through the cash shortage in May or April of 1971 (*id.*), and got worse in the middle of the year (*id.*). A contemporaneous memorandum prepared by Mr. Skaar (A3629) shows that Siegel told Ford Motor that "[c]ollections in May *were very disappointing*" and "the **August collections** *were terrible.*"

At trial Citibank's Mr. Siegel did not basically differ with Mr. Skaar's report,[49] and the District Court itself remarked at the close of trial that the evidence "suggested to me quite clearly that had Mr. Thompson called Mr. Siegel, instead of Mr. Waldman, an entirely different re-

[49] When asked whether there were "any special problems" at the time of the July 13 and 14 meetings with Topper management, Siegel testified that he could not "ignore the fact that there was some concern" during this period (A1297), and that the high percentage of past due receivables "represents obviously not a good picture" (A1327). And when asked by the Securities and Exchange Commission whether the fact that 50% of Topper's receivables were not current at the end of June was "unusual" for the Topper account, Mr. Siegel replied: "Oh, *yes*, it was unusual; the whole program was unusual; the whole situation was unusual. It reflected what I would consider a serious condition" (*id.*).

sult might have followed" (A1526). Another Citibank officer, Mr. Lusk, acknowledged on cross-examination that the $10 million cash shortfall in the months preceding the Private Placement was without precedent in the history of the Topper account (A1258).

7. *Citibank's Management of the Topper Account Is Irrelevant*

Aside from the conclusory testimony of Citibank officers that Topper was a "good credit" in the summer of 1971,[50] the principal evidence in support of the conclusion that Waldman acted in good faith was the testimony of Citibank's expert witness, Mr. Silverman, who testified that Citibank managed the Topper account during the summer of 1971 in a "prudent and very professional" manner from the point of view of a secured lender (A1433). With this conclusion, plaintiffs do not disagree. In light of Topper's financial travails, it was prudent for Citibank to protect its own collateral by refusing to advance against various categories of receivables (Fdgs P101, P105, P284) and by conditioning its bridge loans on Topper's ability to secure additional funds from outside investors (Fdgs P275, P281, P288). It was also prudent under the circumstances for Citibank to reduce its own share of the outstanding Topper loan by $5.3 million in the twelve-day period from September 17 to September 29, 1971 (Fdg P295).

However, what counts here is not whether Citibank did a good job for itself, but whether Citibank was obliged under the circumstances to disclose material and adverse facts to a prospective investor who was considering providing the same funds on an unsecured basis which Citibank refused, because of its special knowledge, to lend even on a secured basis. On this score, Mr. Silverman's testimony has no bearing at all.

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[50] Skirting the basic issues of Topper's financial problems, Citibank witnesses were simply asked as secured lenders what their view of Topper was "as a credit" during the period May through September. With the question thus phrased, Citibank officers were able to reply that it was "adequately secured" (A1215), "amply collateralized" (A1373) and "satisfactory" (A1291).

8. *Citibank's Claim That Topper Was a "Good Credit" Is Inconsistent With the Facts*

Weighed against the *ipse dixit* of Mr. Waldman and his subordinates at Citibank is undisputed evidence showing that Waldman and Citibank, on any objective reckoning, knew there were "problems" with the Topper account. Here as in *Texas Continental Life Insurance Co.* v. *Dunne,* 307 F.2d 242, 249 (6th Cir. 1962), Citibank's claim that it "acted in good faith" is contradicted by "acts of the character which the undisputed evidence in this case shows." And Waldman's "assertion does not weigh heavily against the undisputed facts to the contrary." *Flynn* v. *Crume,* 101 F.2d 661, 664 (7th Cir. 1939). To repeat, "Behavior rather than words among men and women is most significant in ascertaining intent." *Speed* v. *Transamerica Corp.,* 99 F. Supp. 808, 821 (D. Del. 1951), *aff'd,* 235 F.2d 369 (3d Cir. 1956).

V.

Citibank Is Liable to the Pension Fund for Breach of Common Law Duties Arising Out of Its 1950 Agreement.

Since 1950 when the United States Steel Corporation decided to manage its pension funds internally (A819), the Pension Fund and Citibank had been parties to an agreement under which Citibank, in return for an annual fee, undertook to provide the Pension Fund with certain custodial and investment advisory services (A3653). Among other things, the 1950 agreement obliged Citibank to provide the Pension Fund "with investment advice . . . with respect to any cash held by the [Pension Fund] for investment" (A3654), and Citibank allocated 25% of the fees received from the Pension Fund to providing such services (A1672). Thus in 1971 the Pension Fund paid Citibank $96,671, and Citibank allocated $24,167 of that sum to investment advisory services (*id.*).

Over the years investment advisory services provided the Pension Fund by Citibank were of two types: *First,* at quarterly meetings Citibank and the Pension Fund discussed investment policy on publicly-traded securities (Fdg D275); and, *second,* the Pension Fund from time to time requested, and Citibank provided, information relating to certain private placements being considered by the Pension Fund (Fdgs D276-D278).

With respect to proposed private placements, information provided by Citibank was generally given over the telephone (A876) by a Citibank officer familiar with the issuer (Fdg D276), after the Pension Fund had telephoned the Citibank liaison officer responsible for its account to request such assistance (A827-A828). The practice of asking the Citibank liaison officer to select the bank officer who was best-suited to provide information in connection with a proposed private placement began in the mid-1950's and continued through the Private Placement (A827-A831). The District Court found that Citibank rendered such assistance in connection with at least six private placements prior to August 27, 1971 (Fdg D278). On those occasions, the issuer was a present or former client of Citibank and Citibank provided the Pension Fund with information already in its possession (Fdg D279). As a result of this course of dealing with Citibank, by 1971 the Pension Fund believed that Citibank's assistance had been rendered in good faith and based solely on the Pension Fund's best interests (A833).

Apart from the claims of all plaintiffs under the federal securities laws, the Pension Fund maintained below that by failing to disclose material facts regarding Topper's finances, or at a minimum alerting the Pension Fund to the fact that Topper was in trouble, Citibank breached common law duties under the 1950 agreement. This claim was rejected by the District Court, however, because in its view the telephone call from the Pension Fund was not a request for "investment advice pursuant to the advisory contract or any special relationship the Fund had with the Bank" (A28), but simply a request for information (Fdg D238).

At issue here, then, is whether the 1950 agreement obliged Citibank, if requested, to provide information relating to the value of a security rather than a recommendation on purchase or sale. At the outset neither the 1950 agreement nor the 1959 amendment defined what investment advisory services Citibank was obliged to render. The law is settled, however, that "[w]here ambiguity is present in a contract, the subsequent conduct of the parties may be used to indicate their intent." *Gordon* v. *Vincent Youmans, Inc.*, 358 F. 2d 261, 264 (2d Cir. 1965); *see Old Colony Trust Co.* v. *City of Omaha*, 230 U.S. 100, 118 (1913). "[T]here is no surer way to find out what the parties meant than to see what they have done." *Dow Chemical Co. (U.K.)* v. *S. S. Giovannella D'Amico*, 297 F. Supp. 699, 706 (S.D.N.Y. 1969).

In light of these principles it is clear that prior to this litigation both the Pension Fund and Citibank understood that the investment advisory services contemplated by the 1950 agreement, which was the only contractual relationship between the parties (Fdg D267), included an undertaking to provide information concerning a company's financial condition, and thus the worth of its securities[51] rather than any ultimate recommendation to buy, hold, or sell. Over the more than two decades during which Citibank's investment advisory relationship with the Pension Fund had evolved prior to the Private Placement, Citibank, according to Citibank's liaison officer to the Pension Fund, uniformly refrained from making any recommendation to buy or sell: "Certainly, we don't tell them, 'Gee, this is good stock, buy this one, and it is time to unload that.' or what not" (A2012).[52] Rather than paying for any ultimate

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[51] That providing information on the value of a security, as well as a recommendation on a purchase or sale, is within the range of services generally provided by investment advisers is apparent from *Securities Research Corp.*, [1971-1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,790 (1972).

[52] As the Court below found, Citibank's "advice" to the Pension Fund was "*never* cast in the form of recommendations that the Pension Fund buy, hold or sell a specified number of shares or other securities of a particular corporation; but consisted merely of responses from Citibank to a particular request for information from persons in the commercial or credit area of Citibank believed to possess particular expertise concerning the specific subject matter of interest" (Fdg D276; emphasis added).

opinion from Citibank with respect to purchase or sale—the sort of decision which the Pension Fund's management was paid to make—the Citibank liaison officer invariably arranged for another Citibank officer simply to provide the Pension Fund with the facts requested from Citibank's own files.

This unbroken course of conduct by the parties over more than twenty years best reflects their mutual understanding as to the type of investment advisory services provided for in the agreement. If Citibank differed with this construction, it had ample opportunity to say so on each of the prior occasions when the Pension Fund requested, and received, such information. It failed to do so, however, recognizing, as one commentator observed, that "[i]t is access to the internal affairs of its borrowers that attracts many people to entrust their funds to bankers as fiduciaries." Harfield, *Texas Gulf Sulphur and Bank Internal Procedures Between the Trust and Commercial Departments*, 86 Banking L. J. 869, 873 (1969).[53]

The same procedure followed by the parties in prior transactions was utilized by the Pension Fund, with the permission of Topper management,[54] in connection with the Private Placement. As a result Citibank had an affirmative duty of disclosure to the Pension Fund under the contract[55] which Citibank breached when it misstated and concealed material facts bearing on the value of the securities at issue. And this conclusion, unlike plaintiffs' claims under the securities laws, applies even though the report was simply negligent and given without scienter. *See International Products Co.* v. *Erie Railroad*, 244 N.Y. 331, 336-38, 155 N.E. 662, 663-64, *cert. denied,* 275 U.S. 527 (1927); *Restatement of Torts* § 552 (1938). Here as in *Consolidated Oil & Gas, Inc.* v. *Ryan,* 250 F. Supp. 600, 607 (W.D. Ark.), *aff'd,* 368 F.2d 177 (8th Cir. 1966),

> "the parties . . . dealt with each other over a substantial period of time, and confidence has been reposed by

[53] The author of this article, Mr. Harfield, is a partner in the law firm of Shearman & Sterling, long-time counsel to defendant Citibank.

[54] *See* Fdg P18; A1414-A1415.

[55] *See supra* at 37-38.

each in the other. The plaintiff had in the past relied upon the truthfulness and integrity of the defendant in his dealings and his report to it. The circumstances out of which their relationship began and continued and up to the transaction which is the basis of this action created a relationship of confidence and trust between the parties. Apart from the technical elements of a fiduciary relationship, the circumstances surrounding these parties' various dealings made it incumbent upon the defendant to truthfully disclose facts in his possession affecting the value of the [Topper securities] and his partial disclosure, combined with his concealment, amounts to such a misrepresentation to entitle the plaintiff to relief."

CONCLUSION

The Judgment of the District Court should be reversed and the cause remanded to the District Court with instructions to enter judgment for plaintiffs in the amount of their investment and interest from the date of purchase, less sums received by way of settlement from other defendants, plus costs and disbursements.

Dated: January 31, 1977.

Respectfully submitted,

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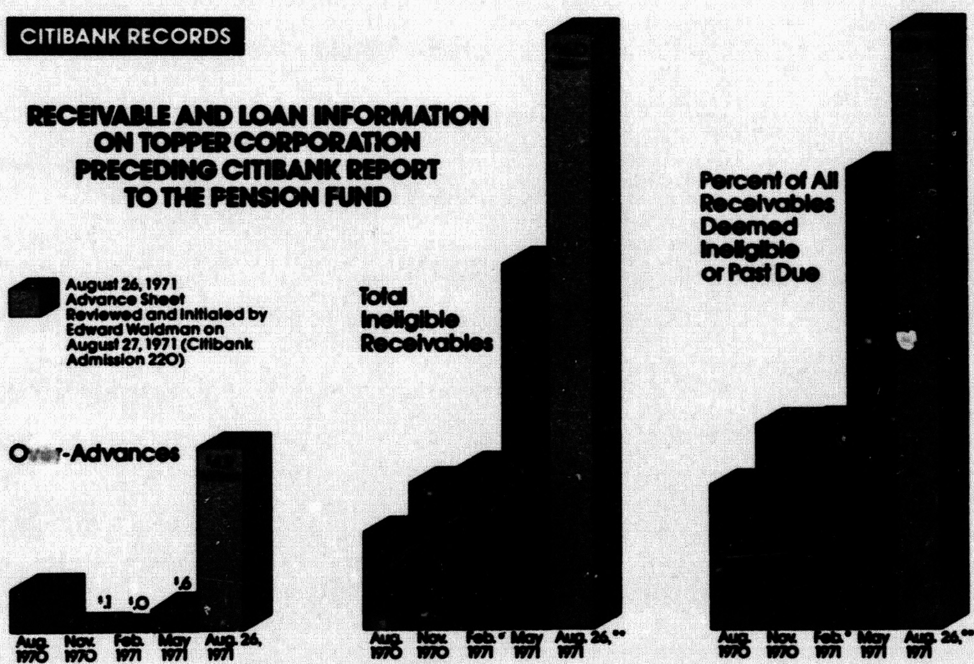
ADDENDUM

PX 1442 CITIBANK RECORDS

RECEIVABLE AND LOAN INFORMATION ON TOPPER CORPORATION PRECEDING CITIBANK REPORT TO THE PENSION FUND



See Footnote on PX 1441 relating to 'Drop Ship' adjustment.
**See Footnote* on either PX 1440 or 1441 relating to 'Redating' adjustment.

SOURCE: Citibank Daily Advance Sheets for August 31 and November 30, 1970 and February 26, May 28, and August 26, 1971 (PX 62[illegible]5, PX 1465, PX 1468, PX 1471, Citibank Admissions 220, 571 & 573 and Citibank Revised Request for Admissions 18)

UNITED STATES COURT OF APPEALS
SECOND CIRCUIT

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UNITED STATES STEEL AND CARNEGIE PENSION FUND, INC., CONNECTICUT MUTUAL LIFE INSURANCE COMPANY, et al.,	:	
Plaintiffs-Appellants,	:	AFFIDAVIT OF SERVICE ON PERSON IN CHARGE
-against-	:	
HENRY ORENSTEIN, FIRST NATIONAL CITY BANK, HAYDEN STONE INC., et al., Defendants,	:	
-and-	:	
FIRST NATIONAL CITY BANK,	:	
Defendant-Appellee	:	

- -x

STATE OF NEW YORK)
: ss.:
COUNTY OF NEW YORK)

being duly sworn, says: I am employed in the office of Breed, Abbott & Morgan, 1 Chase Manhattan Plaza, New York, N.Y. 10005, attorneys for the Plaintiffs-Appellants in the above action.

On the 31stday of January 19 77, I served the annexed BRIEF OF PLAINTIFFS-APPELLANTS

on the attorney(s) listed below by delivering the same to and leaving the same with the person in charge of said office(s

Shearman & Sterling, Esqs., Attorneys for Defendant-Appellee,
53 Wall Street, New York, New York 10005

Sworn to before me this
31st day of January 1977 Al. Morello

Ann Maria Brennan
ANN MARIA BRENNAN
NOTARY PUBLIC, State of New York
No. 24-4527152
Qualified in Kings County
Certificate filed in New York County
Commission Expires March 30, 1978